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Chancellor's (Lawson) Papers: International Committee on Debt Management

DD's : 25 Years

22/3/96 .

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FROM: A C S ALLAN
DATE: 30 September 1988

MR LANKESTER

cc PS/Economic Secretary
Sir G Littler
Mr H P Evans
Mr Mountfield
Mr Walsh
Mr Tyrie

LDC DEBT MANAGEMENT

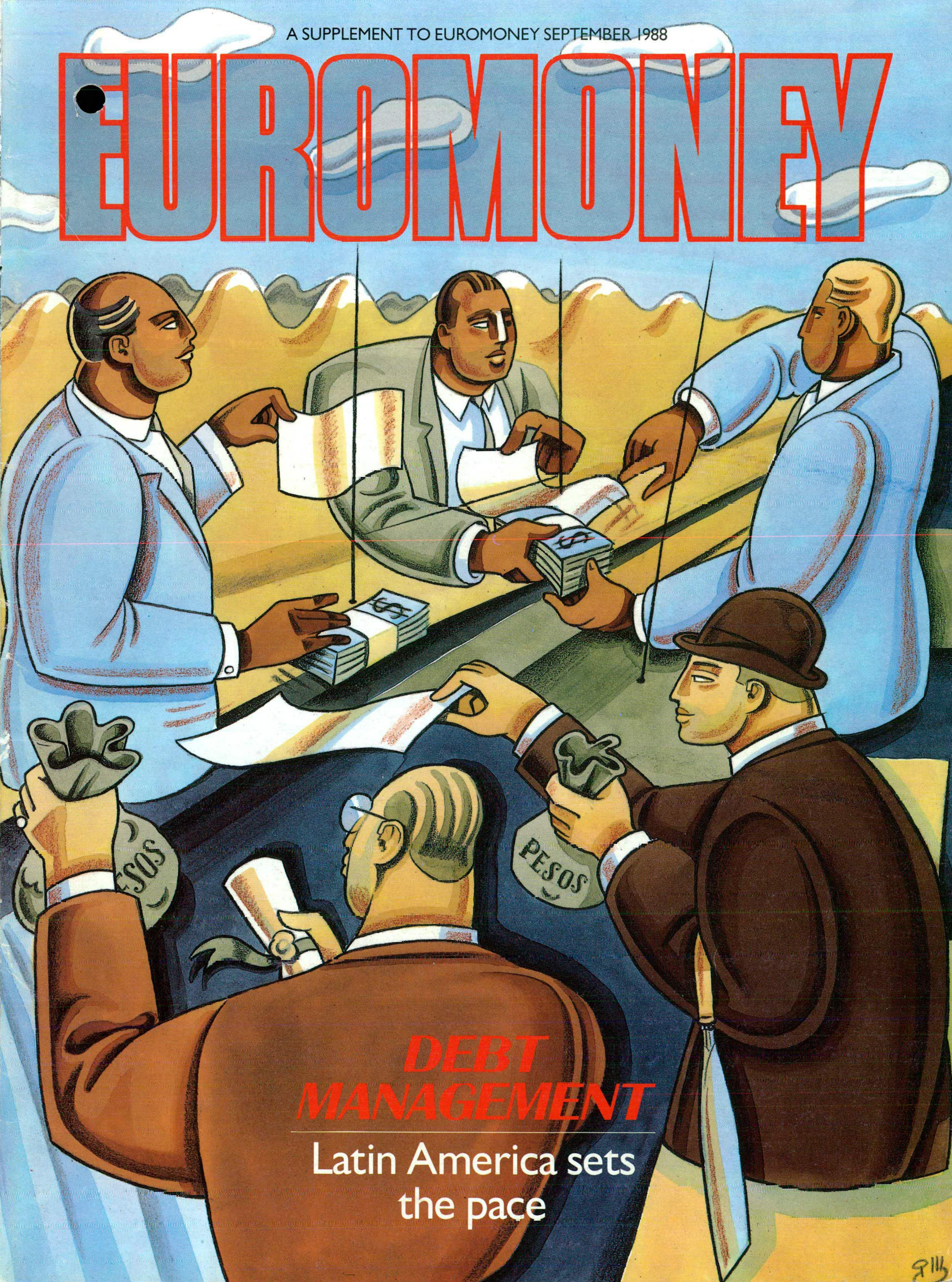
The Chancellor was struck by the attached supplement to the latest Euromoney (attached for top copy only). The text - and especially some of the advertisements - seemed to indicate a much more active use of new instruments for debt management than the Chancellor had realised was taking place. He would be interested in your comments.

ACSA

A C S ALLAN

A SUPPLEMENT TO EUROMONEY SEPTEMBER 1988

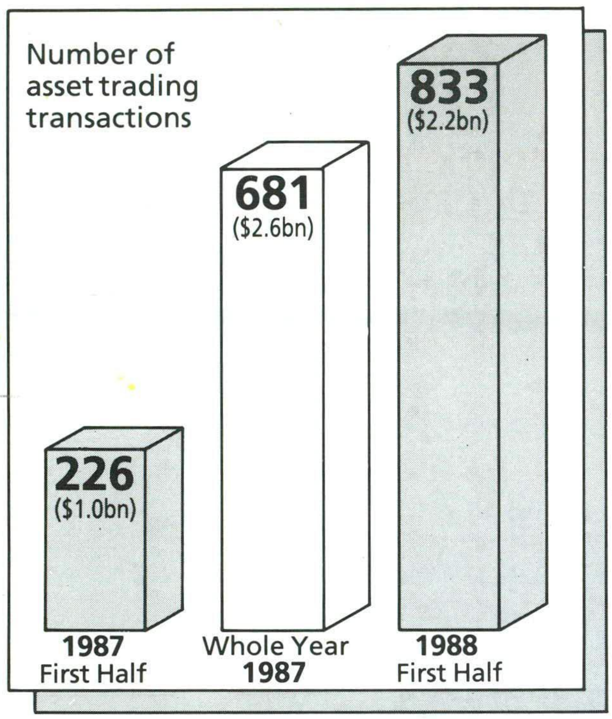
EUROMONEY



DEBT MANAGEMENT

Latin America sets the pace

LIBRA BANK PLC



The Leading Force in LDC Debt swaps

833 transactions were completed during the first half of 1988 with 215 banks and corporations in 29 countries for a total amount of

US$2,238,836,000

for the first 6 months of 1988

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30 June 1988

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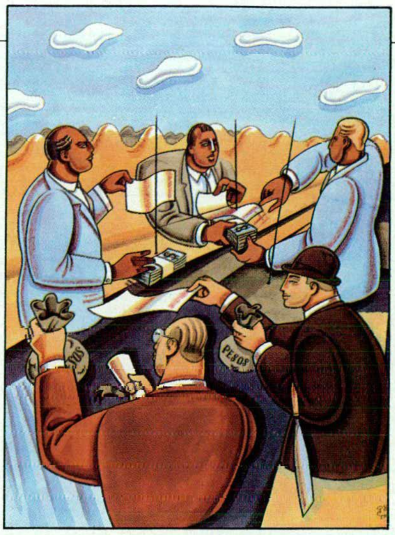

Cover illustration:
Fiona MacVicar

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Advancing with Decree 1988

This supplement is presented independently by *Euromoney*. It was edited by Ron Cooper and Paul King.
Co-ordination: Leslie Holstrom and Simon Brady.

THE QUEEN'S AWARD FOR EXPORT ACHIEVEMENT 1983 1986

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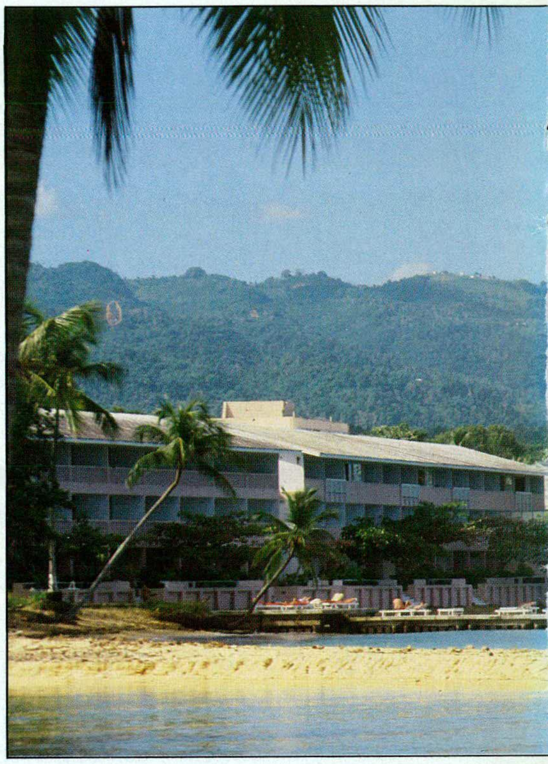
No easy path for debt/equity swaps

In some economies with a good infrastructure and potential growth, debt/equity swaps succeed. In others pitfalls lead to fraud and abuse of the system reports Melissa Wanamaker.



Jamaica: the heat is on for debtor countri

Swapping debt for equity came as a lifeline for lesser developed countries – but one with too many flaws for uniform success.

The concept is simple. A debt for equity swapping programme allows a bank, a multi-national company or other investor to take external dollar debt and bring it to a debtor country's central bank. In the case of Mexico, for example, the debt will be paid at full face value in pesos.

The bank or company can use the pesos to purchase an equity interest in a local project. In this way many banks and companies have become equity owners of hotels, pulp plants, auto assembly factories, and so forth. The banks hope these projects will succeed, and, in time, pay off, handsomely.

At the same time, when sovereign external debt is exchanged for local currency, that amount of LDC debt is cancelled by the country and the bank. Moreover, if the bank was to sell its original external debt on the secondary market it would have to sell it at a deep discount to face value. Companies, on the other hand, see debt/equity as a real incentive to investment.

In practice, each country formulates its own programme, with its own regulations, often shutting down the entire programme at will.

A handful of debt/equity programmes operate or are on the books, in Latin America; there are ones in the Philippines, Nigeria and Morocco, and tiny ones in Jamaica and the Dominican Republic. Each operates independently of the others, but all variously excite or frustrate bankers and foreign investors.

Although the LDC countries would appear to hold all the cards, since they control the "window of opportunity," Neil Allen, group head of Banker's Trust Latin American merchant banking department in New York, believes: "The countries hold some of the cards. The real problem is the countries themselves need investment and need growth, and that's the biggest card of all. And that's the one that they can't do on their own, and so, whatever the weight on the other side, the terms of what the national attitudes are, and what the laws are, in the end the countries come back to the most important thing, which is economic growth and job creation.

"Where you've had a Peru or a Brazil that have tried to go it alone, they've found that, in fact, it hasn't helped them. And even more important, what's happened is, in trying to go it alone, they've ended up at odds not only with the foreign community, but with their own local business community. So in the end they've come back to staring at their biggest problem, which is jobs, employment, and growth."

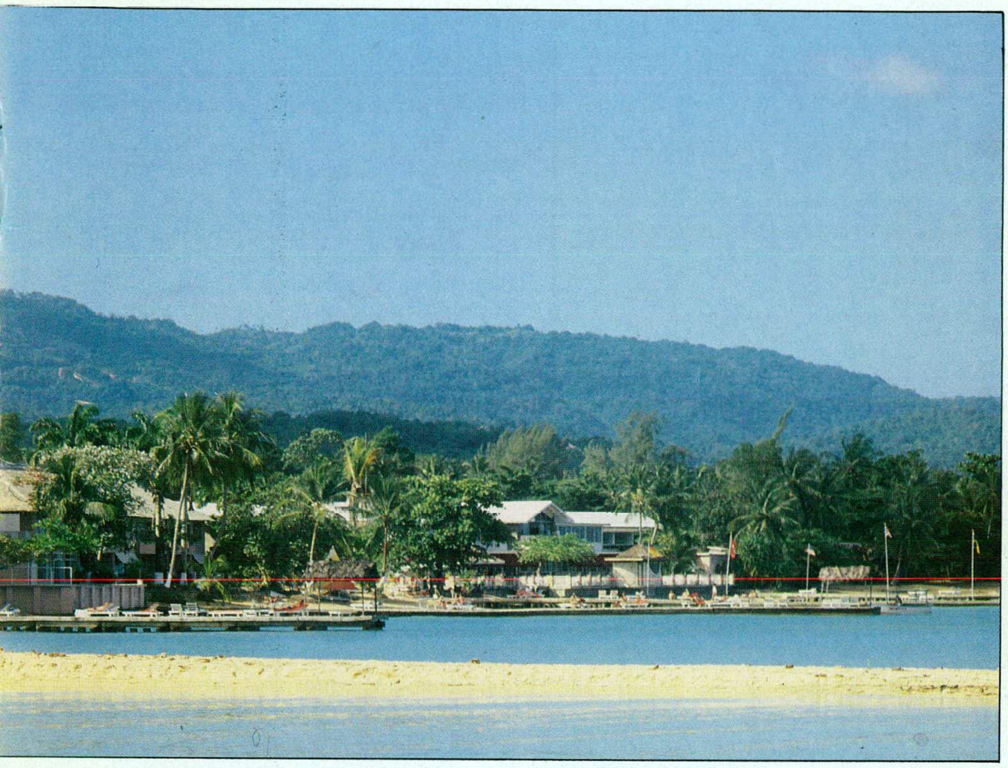
Everyone, including Allen, cites the remarkable example, and exception of Chile, which has made a significant dent in its external debt situation since 1985. According to Fulvio Dobrich, senior vice-president in charge of debt/equity swaps for Manufacturers Hanover Trust's own LDC portfolio: "Chile has had the most successful debt/equity programme and has been able very substantially to reduce its commercial bank debt, from something like $14 billion to $11.5 billion. That's a substantial reduction in any terms, and most of it is through the debt/equity programme.

Allen: "economics and politics"

"Ironically enough," claims Dobrich, "the debt crisis has brought about a situation where probably for the first time there is an availability of venture capital for these countries. If they don't take advantage of it, it's to their detriment in the long run."

Originally, Chile was highly dependent on copper, which left it vulnerable when commodity prices collapsed in the early 1980s. When Chile sponsored its debt/equity programme, "they went out and identified needs, such as wood and agricultural products, where they might find a niche and gain an advantage," according to Manufacturers Hanover Trust's Dobrich.

Certainly Chile's efforts have paid off.



s – *but is debt/equity the way out?*

New investments and new money have poured in. The largest debt/equity swap ever transacted is currently under way. A consortium of foreign investors, the Forestal e Industrial Santa Fe, made up of Royal Dutch Shell Group, Scott Paper, and Citibank, will, debt/equity convert some $350 million into a Chilean wood pulp project.

An additional $70 million of new money will be added, making a $420 million investment overall. Citibank's 20% stake is a non-operational one, thereby freeing it of the usual "trouble" of running the plant, a complaint many lenders have levelled at debt/equity schemes.

The regularity and orderliness of Chile's programme have been important facets of its success. "Chile is the only programme that has been in place, sustained, consistent in its approach and implementation," says Bob McDonald, chief of Chase Manhattan's American operations. Programmes that are off again – on again, hinder confidence and worry bankers.

"Of course, the big question mark in Chile is whether General Pinochet will be 're-elected', so to say," observes Juan Carlos Casas, vice-president, Merrill Lynch Capital Markets in New York. "If he is, there's no doubt that debt/equity will continue. He has produced an investment boom in that country. I think the debt/equity conversion has helped a great deal, so the results are there and they are very favourable."

Pinochet: encouraging debt/equity

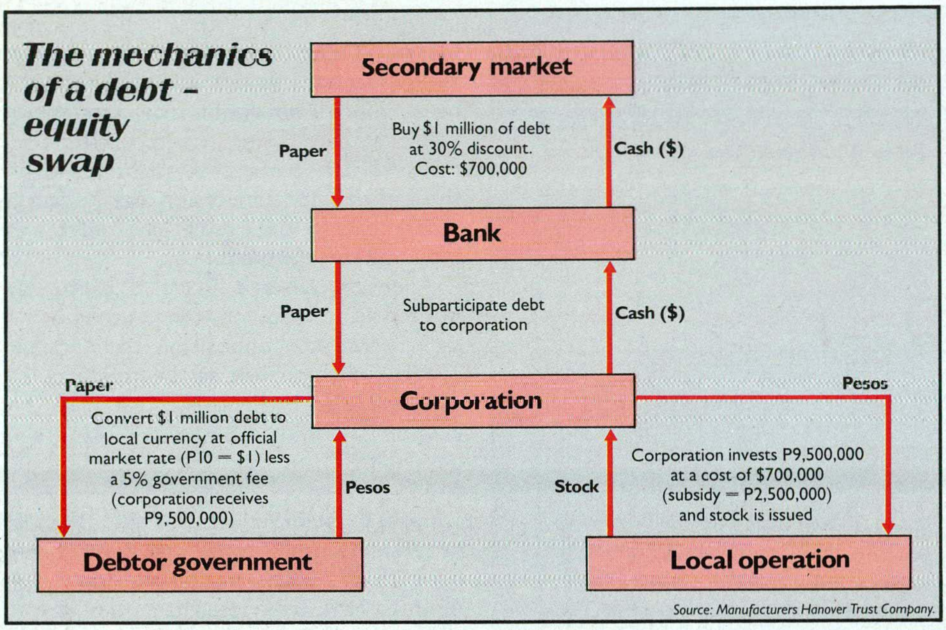
Allen of Banker's Trust is cautiously optimistic. Whatever the outcome he says, "Even the opposition to Pinochet recognizes that Chile has been improving economically . . . In the end I think the economics and the politics will interact in determining the outcome of the plebescite."

Chile's example shows that such a programme can work to everyone's benefit. Elsewhere in the world, things seem to have been less than exemplary.

Mexico had a programme that was going along nicely. Deals were getting done. Then down came the conversion window. The Mexicans said debt/equity conversion was inflationary, because every time external debt was presented to the central bank for conversion into local currency more pesos were printed. But bankers and governments know there are ways around that, such as issuing 20-year Treasury bonds instead. So the real reasons for suspending the programme were not the ones given.

"The fact that Mexico closed its debt/equity programme had little to do with how their programme was progressing, since it was in fact very successful," says Susan Segal, senior vice-president, Manufacturers Hanover. "In fact, I think the decison to keep a debt/equity programme open or shut is more of a political decision."

Segal's colleague, vice-president, Lori Silverberg, agrees: "The important thing to remember is that debt/equity is a very political issue, even when you talk about purely economic ramifications, because, depending on your government policy orientation, you view it in that context. And so, the likelihood of the government to maintain, or to open up, a formal programme, I think has little to do with the private sectors of the countries, little to do with the bankers sitting around the tables negotiating the debt package, and little to do with anyone but the economic



powers in the governing countries. They may offer a programme in individual countries, but may never implement it."

Like banking and investment banking, corporate finance advisory business has been steadily increasing. Silverberg of the corporate advisory side of debt/equity says: "There is a huge market out there – a real demand world-wide – from Asia, Europe, the USA, and Canada. Multinationals are seriously looking at their existing Latin American operations."

Over the last seven or eight years multinationals undercapitalised their subsidiaries during the debt crisis. Now many are eager to revitalise plants and factories through the use of debt/equity incentives. Not only did they need to recapitalise but, as Silverberg says: "They saw the advantage of getting a buck at 70 cents."

LDC debtor countries do not like outsiders getting such a good deal on what they perceive to be their disadvantage. Fulvio Dobrich explains: "Clearly you have protectionism on one side, protecting the local industry and the desire to bring in long-term capital flows on the other. The longest capital flows have always been equity investments, so you have here a contradiction of objectives, which some of these countries are just dealing with in a political fashion. . . . The Mexicans suspended the debt/equity programme as soon as they were going into an election campaign. Will they reopen the programme? I think they will, in one form or another, yes."

Not quite as sanguine about Mexico is Emilio J Lamar, managing director of Merrill Lynch capital market operations in Latin America. He says: "I think the question now is whether the privatisation push will go on despite the results of the elections. I would say as a result of the elections there will be a more leftist, internationalist influence against the privatisations and maybe against the free market philosophy that exists in Mexico now."

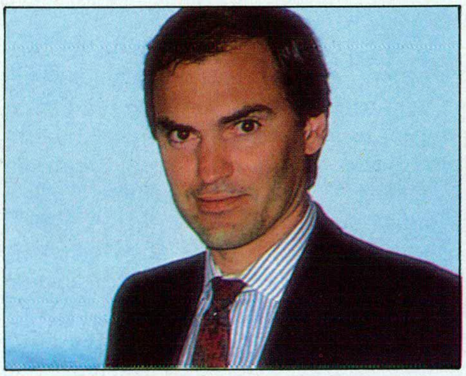
At present Brazil has an active programme with two simultaneous, competitive auctions per month: one in the North and one in the South. The central bank buys the foreign debt at two different prices, which are actively bid for by investors. In the north, or "promoted" area, the discount on July 30 was 11%, but in the south, or "non-promoted" area, the latest discount was 27% of face value, "which means that the investor who bought the debt at 51-52 cents, almost doubled his money," says Emilio Lamar.

Since April this year Lamar's group has been busily marketing a private placement of "the Brazilian Investment Company", the mutual fund put together with Templeton, Galbraith, & Hansberger, along with the Brazilian Bank Itaú. Templeton and Bank Itaú will advise and manage the investments, which are expected to be made with some $150 million of Brazilian debt.

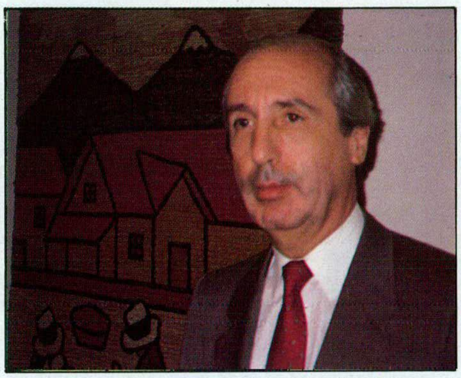
The underlying idea is to get banks, especially those with LDC debt sitting on their shelves, to turn that debt in to the Brazil Fund, who will convert it ultimately into equity investments in the Brazilian stock market.

The banks get rid of the LDC debt at face value against an equal amount of principal in equity shares, net of the auction prices. Ultimately the fund is expected to be listed on one of the international stock exchanges.

Argentina has also begun to turn around economically. Until last February there was no programme. According to Merrill's Juan Casas: "The Argentine government has realised that they have to accelerate this programme." Lamar adds:



Lamar: "results of the elections"



Del Puerto: "growth oriented"

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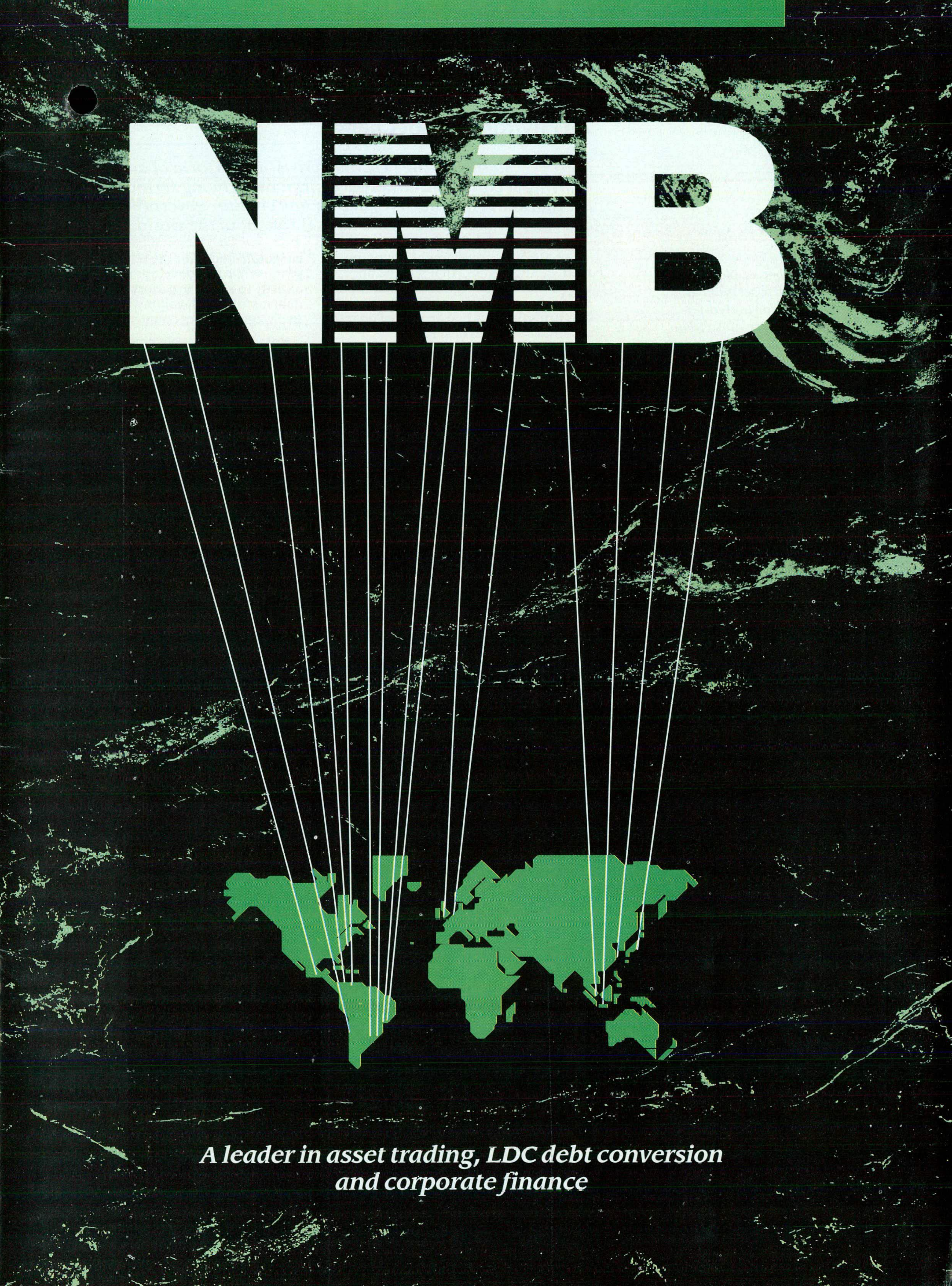

NMB
A leader in asset trading, LDC debt conversion
and corporate finance

NMB BANK

An Environment of Change

Market response to the LDC debt crisis—in the form of an active and evolving secondary market—is continuously being refined to address the market-driven needs of debtor and creditor governments, financial institutions and corporations throughout the world.

A Tradition of International Trade

NMB Bank, one of Europe's leading commercial banks, plays a prominent role in asset trading, LDC debt conversion and corporate finance. Based in Amsterdam, with specialized trading and corporate finance units located in the world's major financial centers, NMB Bank's international character is a heritage of the Netherlands' centuries-long trading tradition.

Since the onset of the LDC debt crisis in the early 1980s, NMB Bank has assumed a leadership position in developing asset trading and debt conversion capacities in the Third World. NMB Bank has done so not as the result of major LDC exposure, but by recognizing opportunities and formulating innovative solutions to these countries' economic problems. By allocating its resources to the vital process of debt adjustment on a global scale, NMB Bank has proven to be a knowledgeable and adroit intermediary for financial institutions, corporations, governments and international private investors who seek access to this evolving market.

The Mexican government's announcement in August 1982 that it could no longer meet its foreign debt commitments sparked a crisis among lesser developed countries that has had an impact on international finance ever since.

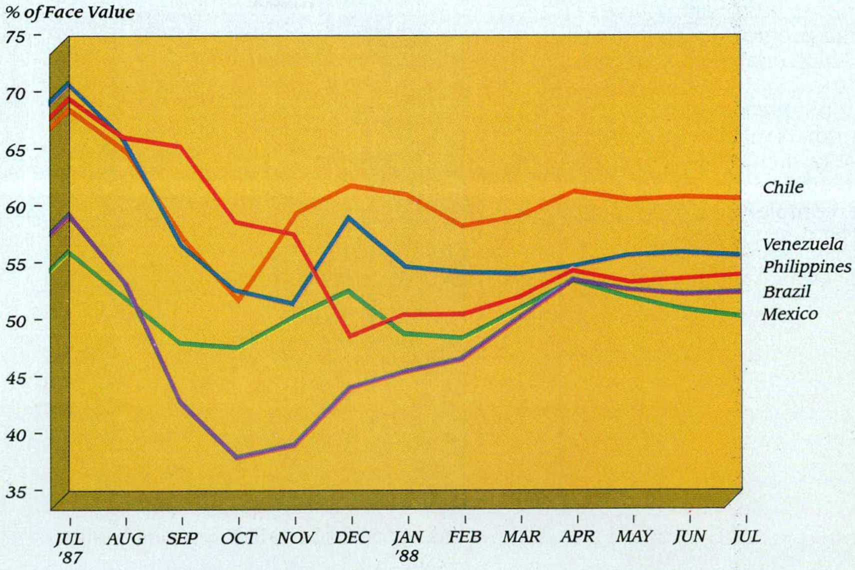
Initially, the various creditors responded by restructuring bank debt of LDCs. However, as this process was repeated in subsequent countries, it became apparent that debt restructuring was an insufficient way of dealing with the escalating problem. Response then shifted, taking the form of a developing secondary market that enabled financial institutions to realign their LDC portfolios.

Essentially a private sector and market-driven phenomenon, this first wave of asset trading was activated by market pressures rather than by concerted government and supranational agency initiatives. Since then, a number of other alternative solutions have begun to evolve, with greater consideration given to the broad impact each approach will have on world markets.

By late 1984, with Brazil's first debt-for-debt relending program, debt swapping became a necessary tool to obtain the specific assets required to satisfy corporate needs for the relending program. While this development stimulated activity to adjust exposure in Brazilian debt instruments, volume remained relatively light in other countries.

Not until the establishment of Mexico's debt/equity program in the summer of 1986 did borrowers, creditors and governments recognize that a true secondary market was developing and as a result, the door was opened for greatly increased trading volume. By autumn of that year, Mexico's public/private swaps and expanded volume of debt/equity conversions—combined with Brazil's and Chile's already established role—had set a pattern for other debtor nations to follow and created an expanded secondary market.

In May 1987, an equally important event occurred. Citibank's announced provision of $3 billion in LDC loan-loss reserves caused a compression among secondary market trading prices (*see chart*), which further paved the way for expanded volume and, along with it, an increased sophistication in trading techniques. Subsequently, the Morgan/Mexico Bond has served as a stimulus for other LDCs to initiate government programs of their own and for many more banks to become involved in the market.



The secondary market is becoming measurably more efficient through a significant increase in both scale and degree of liquidity. The compression of market prices among major LDCs (at about the 50% of face value level) illustrates how the valuation process is based on the ability to trade rather than the underlying economic fundamentals in each country.

The Market Advances

In response to the events of 1986 and 1987, secondary market volume is estimated to have increased from about $2-4 billion in 1985 to nearly $10-15 billion in 1987. In that relatively short period of time, the intensity and scale of trading has served to establish an objective basis for the valuation of claims on highly indebted countries.

As a consequence of the events in Mexico and Brazil—as well as increased loan loss provisions by leading creditors—the secondary market has been increasingly acknowledged as a gauge of sovereign debt value. Perhaps the most noticeable result of today's tighter trading ranges is that inter-country spread trading is becoming more common among most of the major debtor nations. Within those countries, virtually all hard currency denominated instruments and securities are now actively traded for a variety of uses. And, because the secondary market trading emphasis continues to shift to more investment-based transactions, the trend now is increasingly towards meeting corporate demands for investment, rather than the bank portfolio driven adjustment process.

NMB: A Major Participant

NMB Bank's pioneering role in debt trading during the Brazilian market's formative years contributed to the growth of the secondary market. The Bank's aggressive positioning stance provided it with the warehousing capacity to perform both a long and short trading role in an essentially illiquid market, at a time when most secondary market intermediaries were still operating on a matched trading basis.

This expertise in trading–dating from the earliest days of LDC debt swapping activity–serves NMB Bank well today. As trading and corporate finance become increasingly intertwined, the ability to deliver debt at a competitive price gives the Bank an edge in structuring the most efficient, cost-effective strategies for its multinational and local corporate clients. It is in this context that NMB Bank continues to focus its efforts in order to expand and serve its corporate/investor and financial institution client base.

Corporate Finance Evolves as a Key Factor

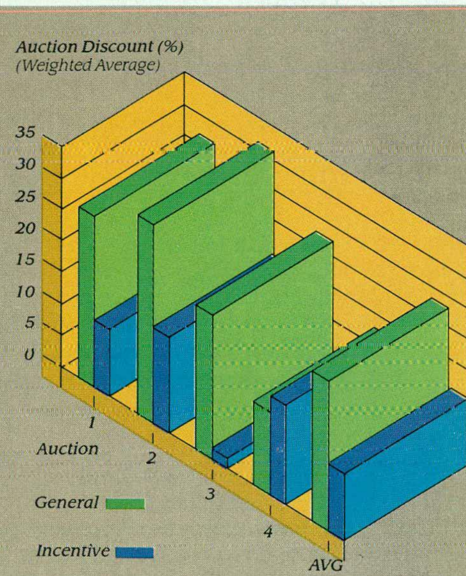
The growth of the LDC corporate finance market is certainly an evolutionary process as many Third World countries recognize that debt conversion will be a key factor in their total debt reduction plans.

In practical terms, each nation draws from the experience of earlier programs and selects particular elements that best meet its individual needs. For example, government-sponsored auctions (based on the 1985 Chilean model) are seen to encourage a freer market, while enabling the LDC itself to capture significant market value for its discounted obligations.

For a variety of political and economic reasons, LDC debt conversion programs tend to be cyclical. To date, the tendency has been to have at least one major program operating at all times, which enables the secondary market to facilitate swaps and cashouts by financial institutions. The expectation is that as the diversity of programs and number of participating debtor nations expands, so will the volume, complexity and opportunities offered by the conversion process.

Brazil–A Closer Look at an Important Market

The current Brazilian debt/equity program is outlined to illustrate and define the mechanics and benefits of that nation's ongoing debt conversion process. Under this one alternative, the Central Bank of Brazil holds two simultaneous auctions each month with local currency disbursement of $150 million. One auction for $75 million is held for conversions specifically in the North and Northeast "incentive" areas while the other "general" auction for the same amount is held without geographic restrictions. The adjacent chart outlines the average auction discount on negotiated debt (taken by the Central Bank of Brazil) resulting from the first four auctions of 1988.



Consider as an example, a multinational company (MNC), which has decided to invest $10,000,000 in the expansion of its subsidiary in the South of Brazil will be used for illustration purposes:

1 The MNC contracts an intermediary bank/brokerage house as its agent to bid on its behalf at an upcoming auction.

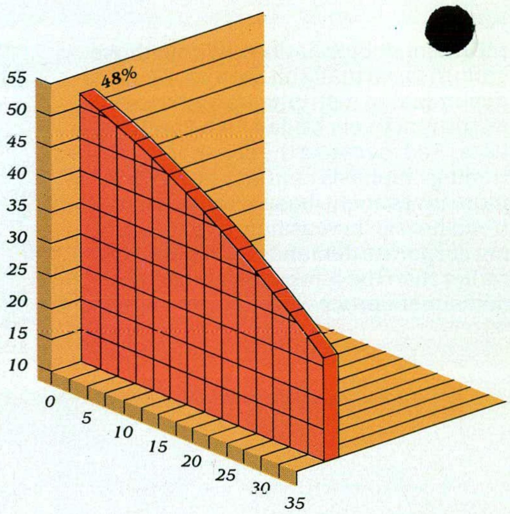
2 The MNC makes arrangements with the intermediary bank to supply deposits eligible for conversion, if its bid is successful in the auction.

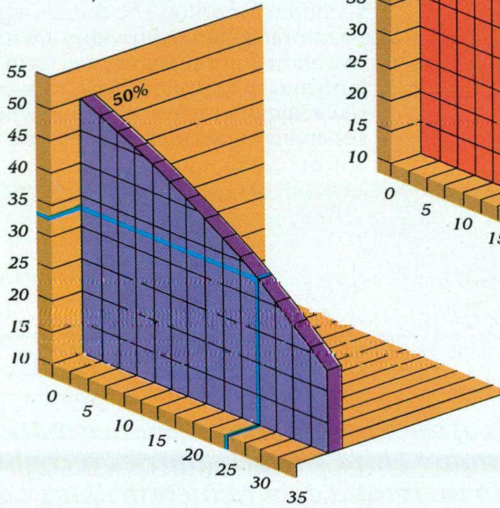
3 The MNC, with the aid of its intermediary, sets the parameters necessary to succeed in the auction.

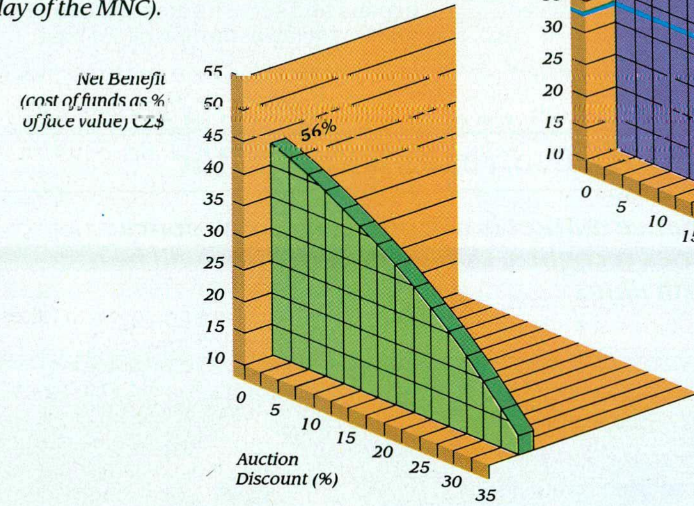
4 Assuming that the MNC is a successful bidder, it purchases the deposits as previously agreed upon, and pays the brokerage fee of 0.15% (on the net amount) as required under auction regulations.

5 Using as an example a 25% auction discount, the MNC will have to purchase a gross amount of eligible Brazilian deposits of $13,333,333.33 in order to yield its proposed net investment of $10,000,000.

Thus, assuming a purchase price for the eligible Brazilian deposits of 50% of face value, the MNC will disburse $6,666,666.67 to obtain $13,333,333.33 of deposits. This results in a *net benefit (discount) to the company of 33.33% on the proceeds of the conversion (or a net yield of 50% of the cash outlay of the MNC).*







These charts represent various net benefits to successful bidders in Brazil's formal auction program. The center chart shows the 33.33% net benefit outlined in the preceding example. The additional charts indicate the net benefits derived utilizing prices of Brazilian eligible deposits purchased at 48% and 56% of face value and auction discounts of 0.0 to 35.0%.

NMB Bank—An Active Leader in Brazil

A leader in debt/equity conversions in Brazil, NMB Bank and its associated brokerage house, Guilder CCT, is the only institution to have successfully participated in all Brazilian auctions held to date for the general and incentive areas.

During the first half of 1988, NMB and Guilder have intermediated and/or acted as principals in Brazilian formal debt/equity conversion programs for 37 clients, converting $182.1 million in affected external debt to yield $156.7 million of registered equity investments. As shown in the chart to the right, NMB/Guilder was a leading participant in the Brazilian debt/equity conversion auction system—the most popular option under the formal conversion program—during the first half of 1988.

NMB Bank is well-positioned to assist companies in determining the most effective strategy for making an investment in Brazil. Support is provided to the Bank's clients during all phases of the financial process, from selecting the most appropriate funding alternative until the actual investment takes place and registration is effected.

Brazilian Debt to Equity Conversion Auction System (Matured Debt Only) Results of First Half 1988—Top 10 Participants

Broker	Associated With	Volume in Millions	% of Total $575.7 mil. Volume	Total Number of Projects	% of Total 134 Projects
FNC	Citibank	108.6	18.9	10	7.5
Guilder	NMB Bank	86.7	15.1	33	24.6
Multiplic	Lloyds	76.4	13.3	5	3.7
Bozano		30.3	5.3	5	3.7
Iochpe	Bankers	28.2	4.9	7	5.2
Tendencia	Evadin	26.3	4.6	3	2.2
JPM	Morgan	25.5	4.4	5	3.7
Novo Norte	Varig	25.3	4.4	12	9.0
Sodril	Boston	20.9	3.6	5	3.7
Boavista		20.3	3.5	4	3.0

NMB BANK

Two Constants for the Future—Change and NMB Bank

Brazil is the engine driving today's international trading and investment activity. Further refinements, however, are underway in countries with existing programs and there is the expectation that new programs in the Caribbean Basin and Sub-Saharan Africa will emerge in the foreseeable future.

In the years immediately ahead, Third World debt conversion is likely to escalate in volume and diversity. Among the trends that can be observed already are an acceleration of local capital market activity, the introduction of increasingly sophisticated local trading instruments, the expanding applications for corporate finance—and, of course, the continuing participation of NMB Bank as an innovative and leading force in each of these areas.

More specifically, NMB Bank anticipates, in the not-too-distant future, growth in private sector recapitalizations, LBOs and new types of debt issues. In Mexico, for example, a combination of these activities has already been implemented in large and far-reaching corporate restructuring programs. Similarly, the pattern is likely to be echoed in Venezuela and other LDCs where a large private sector exists.

Finally, there are indications that Mexico, Brazil and the Philippines are moving towards significantly expanded Merger & Acquisition activity, in which creditor banks will increasingly find themselves participating directly in local equity.

Because NMB Bank is firmly established as a market maker for many types of LDC debt instruments, it is well qualified to pursue debt/equity opportunities and other forms of conversion on a genuinely global basis. In addition, the Bank is involved in government-to-government transactions and supranational agency aid for debt relief—a distinctive position among international commercial banks.

Whatever changes and growth takes place, LDC governments, multinational and local companies can count on at least one constant: the ability of NMB Bank to utilize its knowledge, experience and skill in the global debt conversion markets to help tailor the most effective strategies for meeting its clients' needs.

Asset Trading and LDC Corporate Finance Offices

Branches & Subsidiaries

Amsterdam
Amsterdamse Poort
1102 MG Amsterdam
The Netherlands
Jaap Kool
Jaap Venema
Annette Herfkens
(3120) 5635285

Curacao
Kaya Flamboyan 9
Curacao, Netherlands Antilles
Jesse Spong
(5999) 370000

Hamburg
Ballindamm 17
D-2000 Hamburg 1
West Germany
Robert de Roo
(4940) 302020

Hong Kong
2501, Connaught Centre
1, Connaught Place
Hong Kong
Daisy Ng
(8525) 266031

London
NMB House
2, Copthall Avenue
London EC2R 7 BD, U.K.
Willem Naves
Hernan Caffarone
(441) 6285311

Montevideo
Banco NMB Sudamericano S.A.
Rincon 550
Montevideo, Uruguay
Carlos Pardo
(5982) 960961

New York
450 Park Avenue
New York, NY 10022
Peter Geraghty
Jorge Anwandter
Scott Gordon
Frank Hegeman
(212) 7157300

Paris
8, Place Vendome
75001 Paris, France
Bernard Dennery
Michiel Rang
(331) 42615525

Sao Paulo
Avenida Paulista 967
Cep. 01311 Sao Paulo S.P.
Brazil
Roberto Fonseca
Jordi Wiegerinck
(5511) 2513377

Tokyo
Kokusai Building
1-1 Marunouchi 3-chome
Chiyoda-ku
Tokyo 100, Japan
Yukio Okiyama
(813) 2126481

Rio de Janeiro
Avenida Rio Branco 122
Cep. 20040 Rio de Janeiro
Brazil
Maarten Pronk
(5521) 2210297

Representative Offices

Buenos Aires
25 de Mayo 140
1002 Buenos Aires
Argentina
Hector Pinto
(541) 3315904

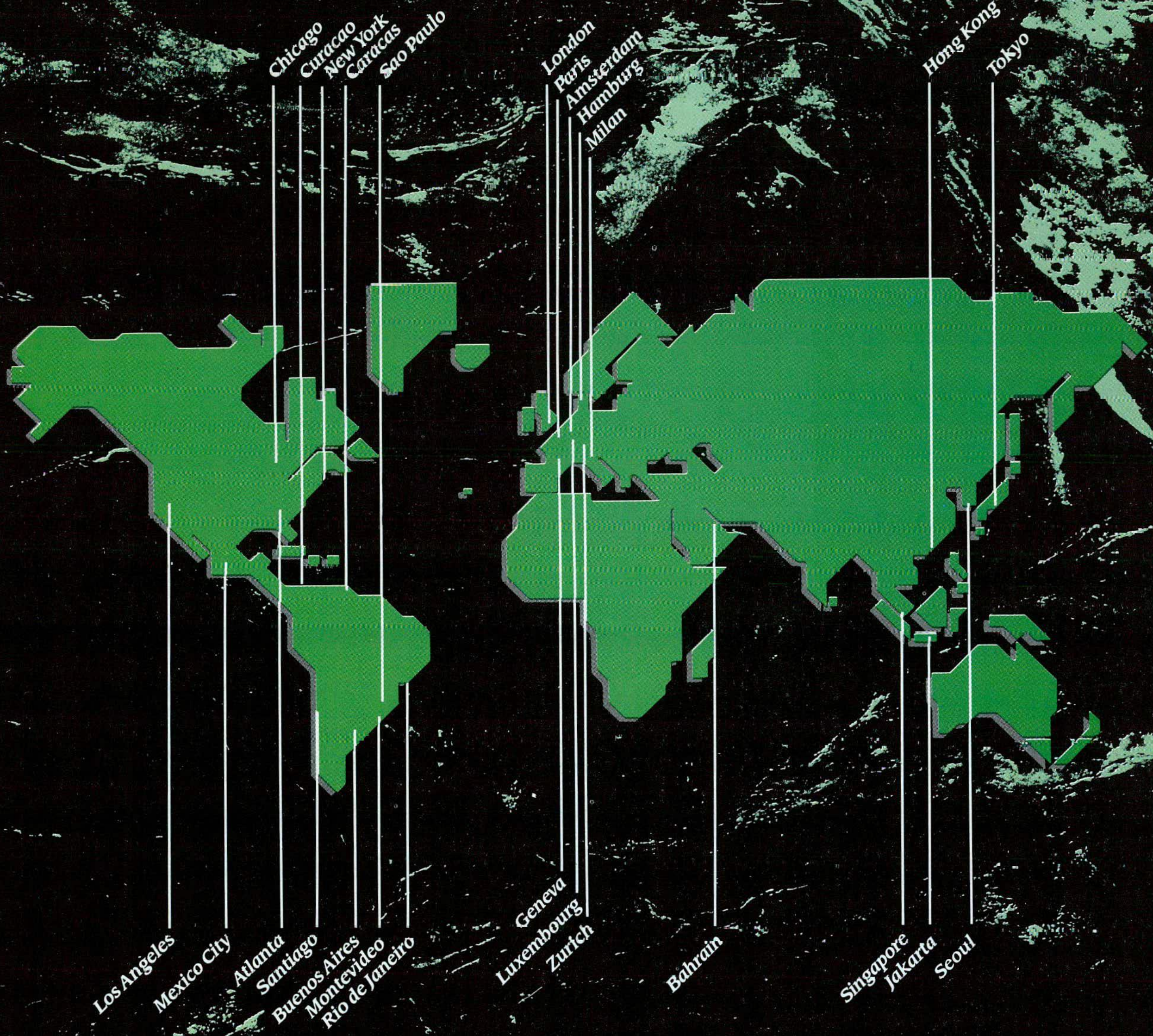
Mexico City
Insurgentes Sur 1991
Edificio A, Piso 6
San Angel, 01020
Mexico City, Mexico
Santiago de Leon
(525) 5501722

Affiliates

Caracas
von Specht & Asociados
Edificio Cavendes—Piso 7
Los Palos Grandes
Caracas, Venezuela
Ralph von Specht
(582) 2616232

Santiago
CMB Chile
Huerfanos 1189
Santiago, Chile
Ignacio Guererro
(562) 6966400

Sao Paulo
Guilder CCT
Rua Libero Badaro, 425
Cep. 01009 Sao Paulo S.P.
Brazil
Eduardo Filinto
(5511) 369101



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NMB BANK

Continued from page 4

"The privatisations are very important in bringing Argentina back into the marketplace, because, one, it's more attractive to investors and, two, if it's tied to debt/equity, it's not inflationary. You get a piece of the company rather than local currency."

In New York Santiago del Puerto, regional general manager of Banco Rio de la Plata is exuberant about the potential for Argentina's new programme, which he helped to design. He stresses three main aspects: "First, it is non-discriminatory. All kinds of external debt can be presented – by foreigners and locals alike. Secondly, it is a growth orientated programme, aimed at real projects, and thirdly, it is a lasting programme.

"The main goal of the Argentine programme is not to reduce the external debt – that happens – but to increase investment. Argentina needs an infusion of capital and we're getting investment there at double the pace of debt conversion."

But, of course, it's not all that easy. The wave of privatisations that Lamar cites are, according to del Puerto: "a very difficult matter. You cannot transform a state-orientated economy as in Argentina to an economy like the United States in a year or two. It's a long process.

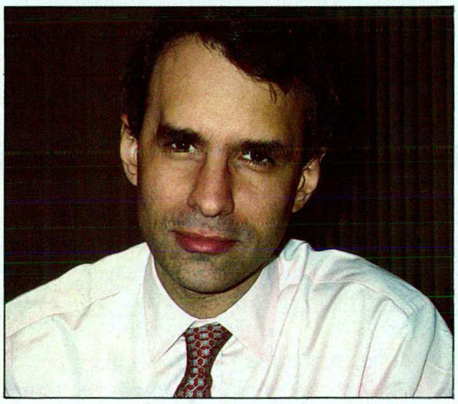
"But I see in my family and friends in Argentina, that they have changed a lot from being nationalistic and chauvinistic ten years ago to being open-minded now. They consider it's much better to have a telephone that works rather than having a national telephone company with no telephone. So they are more mature, more realistic."

Del Puerto addresses another serious matter, to The Third World: flight capital. "Debt/equity is not a solution to the debt problem, but it may be supported by banks and governments. The only solution in the future to the debt problem is to create conditions for the investors to return to the country.

"Just bilateral talks between the governments and the banks will not solve it. What we need is a third party, the investors. They will bring the necessary ideas, the necessary capital for the country to grow. We need economic growth." It is, of course, difficult to know for sure, if the investor is coming back to Argentina permanently, but the results of the first three auctions have been promising: "But of $427 million dollars in projects, $171 million is financed by debt/equity conversion. The rest is new money coming in voluntarily, not like before."

Debt/equity has an uncertain future in the Philippines

Venezuela's debt/equity programme is relatively new, having only been announced last March. Very few transactions have taken place so far, according to John Foley, vice-president, Shearson Lehman Hutton, in New York. "Debt/equity makes sense in Venezuela. It is relatively stable politically there. It has a good infrastructure, undeveloped, arable land in quantity. Importantly, they have substantial cash flow from oil still. Not what it was in its hey day, but still a good base. I see enormous potential," he predicts.

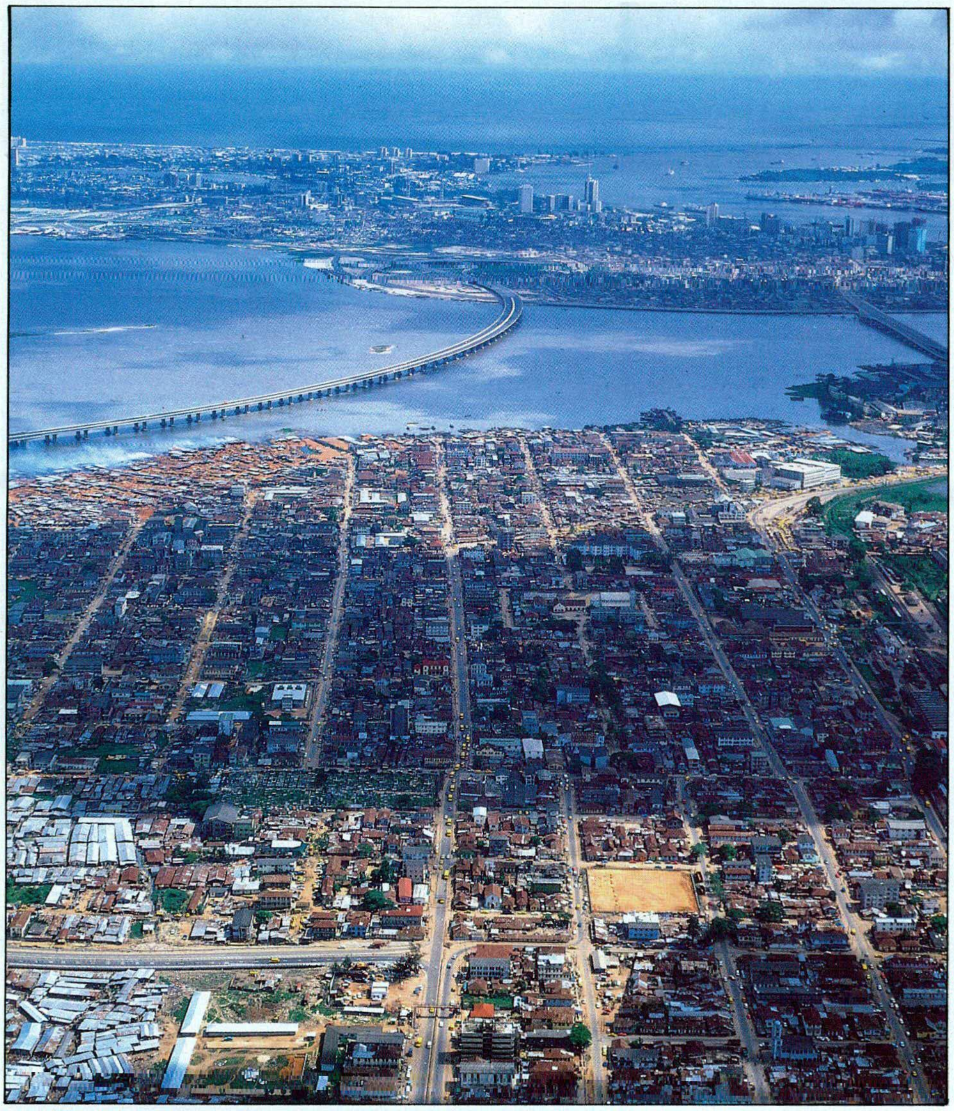


Newman: "just a few countries"

"Over time aluminium could be the major export of Venezuela. They have the basics for a very, very profitable industry." So debt/equity sounds good there, but, as Foley admits, so far nothing much is happening.

Jay Newman, also at Shearson, puts a cautionary flag on the Philippines, where his firm started a fund last year to take advantage of the new debt/equity programme.

Although not worried about Shearson's fund, since it's already in place and the money already converted, he believes the



Nigeria's programme has been clouded by fraud

Philippine government is hesitating to approve more debt/equity projects. He says: "They have a lot of projects under way, including those of the first Philippine Capital Fund, and I think for that reason they want to be quite careful about what they approve." In other words, debt/equity has been successful, but almost for that reason, Newman fears the window might be coming down.

Looking beyond the Philippines to a more global perspective, Newman explains: "What you haven't seen – there are debt/equity programmes, either running or on the books in Chile, Mexico, Brazil, Argentina, Venezuela, Ecuador, Philippines, Nigeria – but that's just a few countries. Very important countries to be sure, but just a few countries. What you haven't seen is the kind of proliferation of debt conversion programmes that many people hoped would occur, with a resulting increase in investment and consequent reduction of debt."

But didn't John Foley say there was great potential in Venezuela? "True," admits Newman, "I'm not saying there isn't. There's opportunity in every country, but what you need in many countries to catalyse them is a programme like a debt conversion plan to get things off and running. Now you have a programme in Venezuela, in Mexico, Brazil, Chile and the Philippines, but there are fifty other countries that don't get programmes. I'm hopeful they will get them, but debt conversion has now been around for four years and you've only got a dozen countries that have implemented them."

The problems of running a successful debt/equity programme are considerable. There are worries about inflation, privatisation, foreigners grabbing assets cheaply, and many programmes never get that far. They also are often beset by crooks and charlatans who cheat the government by various swindles.

Take, for example, the case of the African countries. Only Nigeria and Morocco have formal programmes, but currently neither is working primarily because of abuses. Informal conversions are taking place in Zambia on a deal by deal basis, but a programme like Nigeria's had to shut down to stop the fraud.

One abuse, known as "round-tripping" is especially bothersome to the Nigerians. A foreigner usually brings in funds cheaply through a debt/equity programme and then passes the money out through the black market.

Eric Hermann, associate director, Bear Stearns, and a specialist in African corporate finance, says: "You just make a pure arbitrage profit that way and the country is no better off than it was when it started. You're better off as the criminal, and the reason you're better off is because some of the discount that the bank took when it sold the debt has wound up in your pocket."

Just back from discussions with the Nigerian government on ways to deal with their debt/equity programme, Hermann sums it up: "Nigeria has probably the biggest programme in Africa, certainly in terms of potential. They had a debt/equity programme open for a couple of months ago last spring. Many of the transactions raised local concern about people being paid off and bribery, and such like, and round-tripping, and the programme was abruptly cancelled.

"Now they're trying to come up with a new programme that will prevent the abuses the Nigerians saw in the old programme. We've been waiting about six months now, when any day they could announce a new programme, but I honestly think they are having trouble finding a viable programme."

No doubt it is truly hard, even with the best intentions. A graphic example of the kind of fraud the Nigerians have had to contend with goes like this, according to Hermann: "Say you have a $5 million dollar invoice for the import of Mercedes Benz cars and you really imported rocks and not Mercedes – and the reason you did that is you're importing the rocks from yourself – and then you want to justify the payment at the official rate, not the parallel, or black market rate, of $5 million dollars worth of cash.

"That's an enormous windfall profit when, let's say the official rate is twice as good as a black market rate. If you're just going to take your $5 million and exchange it on the black market, that's only worth $2½ million. If you're going to make a phony trade transaction, and get the $5 million, paid out at the official rate

Angotti: "a very limited opportunity"

that's worth $5 million. That's quite a windfall. That's not every deal, but that's a concern voiced to me in Nigeria."

If you're incredulous that anybody could mistake rocks for Mercedes, says Hermann, "Banks deal in documents. So you come in with bills of lading on a slip of paper that says, 'received five crates of Mercedes, value $5 million dollars,' stamped by a customs official. You go to the Bank, say 'here it is. Now I owe $5 million dollars to Trading Co X overseas, which sourced the Mercedes.' Only *they* are *you*. That now gives you a way to use the official rate to remit cash."

It is well to remember that Nigeria is the biggest debtor in Africa. So what is the outlook for debt/equity conversions, given the bleak status of so many of the few countries that have programmes?

"I've never really been too sanguine about debt for equity conversions," says Tony Angotti, vice-president in charge of sovereign debt at Security Pacific. "I always thought it was a very limited market opportunity and a very limited way out of the debt problem."

Angotti forecasts that it will be the big money centre banks which will continue to do debt/equity conversions, "because they can't afford to sell at a discount on the secondary market. But, by and large, I don't think the American regional banks are going to be too interested in it. It's not that interesting for the regionals or even the super-regionals. . . . Realistically, where can you convert debt into equity?

In Chile. To a limited extent in Brazil. We haven't had a programme in Mexico for a year. In the Philippines, it's ridiculous to try to do a transaction. It's very uncertain. When you're faced with all that uncertainty in these quote, unquote conversion markets, you don't know what the discount is going to be. You work for six or eight months on the transaction and then you have to wait six or eight months more for a deal to get done, it just doesn't make a lot of sense. It doesn't seem that attractive and you still have your money in for 12 years. So they're not doing anything to motivate the banks to convert the debt into equity."

Angotti adds that even though a bank sells external debt and thus cuts its exposure, it still has cross-border equity exposure. "For example, if you sell a million dollars of Mexico debt, your total country exposure has been reduced by a million dollars. If you convert that debt into equity, you still have a million dollars worth of exposure in Mexico. It's a different kind of risk, but it's still Mexican risk," he explains.

A Security Pacific, with loan loss reserves at a hefty 54%, can more easily afford to simply sell out bad loans and cut exposure that way. Angotti says: "we can be much more aggressive in what we do. We can either do debt-equities or we can do sales." A Citibank with only 30% in loan reserves doesn't have the same flexibility. Neither do a lot of the other big money centre banks. They have to like debt/equity and they have to hope it continues to expand and improve.

Some observers, such as Thomas Coyne, of Chase Bank in London, offer little encouragement for the future of debt/equity swaps. At a recent Euromoney seminar in London he gloomily remarked, "Frankly, standing here today, I hope they're successful. I hope they're right. Because at the end of the day debt/equity programmes are a bandaid. They're a solution, a short-term solution to a very long-term problem. I would much rather . . . tell you there are no more debt/equity programmes because they're no longer needed, because all the structural reforms that are necessary to attract you to the country without that incentive have already been put in place."

Indicative prices for less developed country bank loans

	Indicative cash prices		Swap index	
Country	Bid	Offer	Sell	Buy
Algeria	92.50	93.50	6.65	7.67
Argentina	25.75	26.50	0.67	0.68
Bolivia	10.00	11.00	0.55	0.56
Brazil	50.25	51.00	1.01	1.02
Chile	60.75	61.50	1.27	1.30
Colombia	66.00	67.50	1.47	1.53
Costa Rica	13.50	14.50	0.58	0.58
Dominican Republic	19.00	21.00	0.62	0.63
Ecuador	25.50	26.50	0.67	0.68
Honduras	22.00	24.00	0.64	0.66
Ivory Coast	27.50	29.50	0.69	0.72
Jamaica	37.00	40.00	0.79	0.83
Mexico	49.50	50.25	0.99	1.01
Morocco	50.50	51.50	1.01	1.03
Nicaragua	2.00	4.00	0.51	0.52
Nigeria	27.00	29.00	0.68	0.70
Panama	25.50	26.25	0.67	0.68
Peru	6.00	7.00	0.53	0.54
Philippines	53.50	55.00	1.07	1.11
Poland	40.00	41.00	0.83	0.85
Romania	87.00	88.50	3.84	4.34
Senegal	48.00	50.00	0.96	1.00
Sudan	2.00	8.00	0.50	0.55
Turkey	98.50	99.50	82.25	99.75
Uruguay	60.50	61.50	1.26	1.30
Venezuela	54.50	55.25	1.10	1.11
Yugoslavia	47.75	49.00	0.95	0.98
Zaire	19.00	23.00	0.62	0.65

Source: Saloman Brothers Capital Markets Group, August 1988

Geraghty: "it's the beginning"

Since none of that has happened sufficiently, Coyne foresees in 1988 and 1989 "continued use of debt/equity programmes, continued efforts to capture more of the discount." Coyne says we'll see more debt/equity because things are so far from perfect, but what we have seen is a country by country struggle to deal in any way it can with intolerable debt, both internal and external, towering inflation, desperate need for growth and modernisation, and finally, in terms of their own people crying out for jobs and a decent standard of living. The list could go on and on.

If one is to offer a fair assessment of what the banks, the countries, and the people themselves have done, one can say, with Peter Geraghty at NMB Bank: "I wouldn't call debt/equity a bandaid. I think it's the beginning. I think that clearly it was left up to the private sector to take the lead in beginning to deal with the problem. They say it's a bandaid. They say it's window-dressing, but the fact is . . . when you have a problem of this magnitude, you take it off in small bits at the beginning. The market has begun to do that. To a large extent, it's been the countries and the people in the secondary market and corporate finance who've addressed the problem more effectively to date. So, OK, if you take \$5-10 billion off a huge problem, wherein debt has been physically cancelled, and after 1988, it'll be a larger number than that, it's still significant.

"The fact is it wasn't until 1986 when Mexico came up with its debt/equity programme that the market was even recognised to exist, and the market didn't become legitimised until a year ago, when Citibank took the big write-down. So I think it's easy to say it's no big deal, but I think that the fact is that it's only in its beginning and will continue to evolve."

"While we're no means out of the woods on the debt problem, we're in a descending position, not an ascending one," says James McDermott, Jr, executive vice-president, Keefe, Bruyette & Woods, the New York banking analysts. "One could arguably state that five years from now we won't be talking about the LDC debt issue to the same extent that we have over the past five years."

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DEBT-TO-EQUITY CONVERSION IN ARGENTINA

The Argentine debt-to-equity conversion programme has been in effect since the beginning of 1988. Three public auctions have been held so far at the Central Bank of Argentina and all of them have been very competitive, with bids showing increasing discounts. A brief description of what happened is presented through the following highlights:

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Banco Rio de la Plata S.A.

Projects with bids already accepted by the Central Bank represent more than US$427 million total investment in Argentina. Approximately US$172 million of that cost will be financed through Debt/Equity; the rest will be covered from other sources such as export credits from official agencies, domestic or international loans and additional equities.

Nine out of 36 projects already accepted are being managed by Banco Rio de la Plata SA. The aggregated cost of these nine projects exceeds US$135 million which roughly represents one-third of the total. With these results Banco Rio is by far the number one bank in debt/equity in Argentina, being followed by another Argentine bank – Banco de Crédito Argentino – with five projects representing US$68.6 million aggregated cost. Some other 14 banks follow at a respectable distance, completing a universe of 36 projects and US$427.6 million total cost. Table II shows complete information by agent bank.

Total debt rescued by the Central Bank through these three auctions amounted to US$350 million at an average discount of 51%. The average discount on debt converted through Banco Rio – the only bank with winning bids at the three auctions – was 42.7%.

The index that relates the total cost of winning projects to debt/equity financing increased from 1.89 at the January auction to 2.92 at the third one in June. This demonstrates that the programme constitutes a good incentive for investment without substituting other sources of financing.

In contrast to Brazil and Mexico, the Argentine debt/equity programme does not specify priority regions or priority industries in order to give approval to projects or bids. Table I contains a breakdown of accepted projects, by activity.

Discounts offered at the second and third auctions have been substantially higher than the ones resulting from the first bidding. The average discount on each of the auctions has been as follows:

January 20 1988 .... **36.69%**
March 3 1988 .... **53.87%**
June 10 1988 .... **56.50%**

The programme continues to offer a good incentive for investors, despite the increasing discounts on conversions. Taking into account the value of Argentine loans on secondary markets, the average implicit subsidy given to converted debt has been the following:

January 20 1988 .... **97.8%**
March 3 1988 .... **70.9%**
June 10 1988 .... **56.8%**

TABLE I Investment projects, by activity

In US$'000

Activity	Total cost of projects: Amount	Total cost of projects: %	Face Value of debt to convert	Effective proceeds of conversion
Motor vehicles and engineering	79,520.2	18.6	71,994.8	31,765.5
Hotel and resort	77,753.8	18.2	46,529.0	20,104.1
Meat packing and refrigeration	76,041.0	17.8	67,788.9	43,890.9
Food and beverages	74,349.0	17.4	47,708.5	22,221.7
Building materials	34,763.0	8.1	21,119.1	9,184.7
Chemicals and pharmaceuticals	32,253.3	7.5	22,850.0	12,309.5
Apparel and shoe manufacturing	24,396.7	5.7	11,456.1	4,571.0
Agro-industry	12,710.1	3.0	17,401.9	8,370.6
Farming	7,782.7	1.8	10,458.7	4,566.8
Energy and gas	2,979.8	0.7	4,179.5	1,956.0
Textiles	2,778.9	0.7	1,519.0	783.9
Publishing	1,396.0	0.3	1,650.0	708.5
Paper production	951.0	0.2	1,354.0	564.2
Total	**427,675.5**	**100.0**	**326,009.5**	**160,997.4**

Thirty three companies, some of them with more than one project, are the winners so far of this special financing. The list appears in Table III. It is evident that the programme is working well for different sizes of projects and companies. On the one hand, 55% of the *number* of winning projects have an average magnitude of US$1.8 million. On the other, nine companies represent an aggregated *amount* of projects of US$349.5 million, or 81.7% of the total value of projects accepted at the three auctions.

The programme in the future may incorporate additional features or changes geared further to improve conditions for private investment in Argentina. However, an eventual expansion of the debt/equity programme should be offset by appropriate cuts in other expansionary programmes so that the economy as a whole is not overheated. In particular, an expansion of debt/equity targets will affect alternate, though less effective programmes, such as onlending loans and rediscount facilities. Cancellation of rediscounts is now eligible for debt conversion.

Contrary to the effect of onlending loans, which tends to concentrate domestic credit in the hands of a few foreign banks, and the use of such credit on large corporations or local banks, debt/equity seems to serve all purposes better including the financing of relatively small investment projects. Twenty projects out of the 36 already accepted have an average cost of US$1.8 million.

Without interfering with the ability of foreign banks to participate, the programme permits competition by local banks – both private and official – in a way that benefits the whole economy; investors find better service and the government high discounts. Results from the three auctions show three Argentine banks – Río, Crédito Argentino and Ciudad de Buenos Aires – in the leading positions as agents assisting and handling 16 winning projects, representing more then 58% of the debt conversion accepted under this programme.

TABLE II Winning projects, by agent bank*

In US$'000

Agent bank	Total cost of projects Amount	%	No of projects	Face value of debt to convert Amount	%	Effective value of conversion Amount	%	Average percentage of conversion
Rio (**)	135,213.2	31.6	9	110,969.1	31.6	63,544.7	37.0	57.3
Crédito Argentino	68,640.0	16.0	5	62,332.6	17.7	27,250.3	15.9	43.7
Ciudad Buenos Aires	40,695.7	9.5	2	22,180.0	6.3	9,514.4	5.5	42.9
Credit and Commerce SA	38,756.0	9.0	2	51,085.2	14.6	22,222.2	12.9	43.5
Chase Manhattan	38,017.7	8.9	1	24,425.9	7.0	11,700.0	6.8	47.9
Roberts	27,267.0	6.4	3	15,777.0	4.5	6,995.7	4.1	44.3
Morgan	24,396.7	5.7	1	11,456.1	3.3	4,571.0	2.7	39.9
Manufacturers Hanover	20,743.7	4.9	1	12,248.6	3.5	7,716.6	4.5	63.0
Irving	11,528.0	2.7	1	9,990.4	2.9	4,885.3	2.8	48.9
Velox (***)	7,398.0	1.9	4	11,065.4	3.2	4,964.0	2.9	44.9
General de Negocios	4,322.2	1.0	1	6,428.0	1.8	2,757.6	1.6	42.9
Shaw	3,495.0	0.8	2	4,732.4	1.3	1,866.8	1.1	39.4
Francés	2,311.0	0.5	1	838.2	0.2	502.0	0.3	59.9
Florencia	2,052.3	0.5	1	3,909.1	1.1	1,436.6	0.8	36.8
Bank of America	1,865.0	0.4	1	2,001.8	0.6	1,241.1	0.7	62.0
Tornquist	974.1	0.2	1	1,518.6	0.4	681.9	0.4	44.9
Total	**427,675.5**	**100.0**	**36**	**350,958.4**	**100.0**	**171,850.2**	**100.0**	**49.0**

(*) *Including all winning bids. Adjusted to eliminate the effect of partial allocation to auctions established for projects with debt conversion in excess of US$20 million.*

(**) *Three projects with a total cost of US$5.6 million out of the nine projects currently managed by Banco Rio were transferred to this bank after presentation to the Central Bank by Velox.*

(***) *Velox presented to the Central Bank eight winning bids for a total amount of US$13.5 million. Three of those projects were then transferred to Banço Rio as agent and financing bank.*

BANCO RIO

So far, the programme has been managed in a clear, transparent way. Transparency and a perceived stability give the programme special attraction. Competition has been strong and is increasing. This time, it is the participant, who has the opportunity, based on clear rules, to win or lose without bureaucratic interference. In all auctions, the Central Bank decided to cut the list of winning bids immediately above the pre-announced auction amount, thus giving the impression that the government is favouring the expansion of the programme. As this is not the general attitude with respect to other concerted debt programmes, such as onlending, it is a hint that debt/equity in Argentina is running at a smooth pace.

It is expected that the present trend will be maintained so that the Argentine government will reach the 1988 debt/equity targets easily. This means an effective value of conversion of US$300 million that probably will finance projects for US$750 to 850 million, diminishing the external debt by approximately US$600 million. As foreseen today, all possible changes in the programme will contribute to its enhancement, provided it remains simple and transparent.

TABLE III

Local companies receiving debt/equity funding

By magnitude of project

Companies	Total cost Of projects (US$'000)	Financed through debt conversion (%)	Other sources of finance or direct investment (%)
Swift Argentina SA	70,920.0	57.5	42.5
SEVEL SA (three projects)	60,142.0	40.2	59.8
Valle de Las Leñas	40,257.8	23.0	77.0
Cervecería Río Paraná	38,017.7	30.8	69.2
Hotel Corp of Argentina	37,496.0	25.1	74.9
Cementos San Martin	34,763.0	26.4	73.6
Alpargatas	24,396.7	18.7	81.3
Coca-Cola SA	22,751.0	18.5	81.5
Massuh SA	20,743.7	37.2	62.8
Malteria Pampa SA	11,528.0	42.4	57.6
Saab-Scania	10,880.2	41.5	58.5
EM Jeppener (two projects)	8,498.0	36.4	63.6
Maleic SA	7,040.6	29.0	71.0
Inca SA	5,538.2	70.0	30.0
Nutryte SA	5,121.0	61.1	38.9
Calafate SA	4,322.2	63.8	36.2
Citrusvil SRL	3,120.0	66.9	33.1
ATGE SA	2,979.7	65.6	34.4
Quimica Hoechst SA	2,593.0	47.6	52.4
Tinobet SA	2,311.0	21.7	78.3
Olega SA	2,052.3	70.0	30.0
Pioneer Argentina SA	1,865.0	66.5	33.5
Diario La Nueva Provincia	1,396.0	50.8	49.2
ESTAR SA	1,300.6	51.4	48.6
Punta del Agua SA	1,281.2	49.6	50.4
Jojoba Sudamericana SA	1,260.0	20.5	79.5
Farmatecnia SA	974.1	70.0	30.0
Celulosa Cnel Suarez SA	951.0	59.3	40.7
Santa Ursula SA	926.9	70.0	30.0
Laboratorios Beta SA	902.0	70.0	30.0
Textiles San Andres	467.9	60.2	39.8
Los Cuatro Vientos SA	440.8	54.7	45.3
Agrogen SA	437.9	60.1	39.9
Total	**427,675.5**	**37.6**	**62.4**

No time for new toys

Why did the Mexicans ditch a debt/equity swap that fostered new companies and provided much-needed jobs? "Inflationary", insists the Ministry of Finance. Others contend that the government didn't want any competition to a zero-interest bond plan with a better discount.

By Douglas Bartholomew

Mexican debt/equity swaps were popular to the tune of $3 billion over less than two years. That was before the government closed the shutters on the swaps window last October. But despite the moratorium, there remains no shortage of paper looking for a deal as well as companies waiting to get a piece of the action – if and when the ban on swaps is lifted. Unfortunately, the next debt/equity deal in Mexico probably won't take place until 1989, when the new administration takes office.

Why would the government of a nation starved for capital investment and suffering a shortfall of four to five million jobs choose to sink a programme that reduces debt service and fosters new companies that put large numbers of people to work?

"This was a highly successful, very attractive programme," says a senior official of a US bank in Mexico City. "The total foreign investment in Mexico is about $20 billion, and that was accumulated over a period of many years. Of that amount, the debt/equity swaps generated $3 billion, or 15% of the total in just 18 months".

Indeed some of the reasons given for the programme's demise differ significantly from the line given by the Ministry of Finance.

According to Luis Foncerrada, director of foreign financing in the Ministry of Finance, the programme was killed because the government couldn't afford the cost of financing with pesos the domestic debt it caused. The government must issue cetes, or treasury certificates, to get the pesos. "When you convert foreign debt into domestic debt, you have to pay investors in pesos," he says. "With our domestic interest rates running 10 to 15 times those in other countries last year, there was a tremendous pressure exerted on the budget by the swaps. So we had to close the programme to avoid adding much more domestic debt." A vice-president for a large foreign bank in Mexico City agrees, "The budget is the real economic reason they stopped the swaps."

Others surmise that the deals were deemed politically unwise due to a growing sense of unrest over foreign investment, especially with an election year around the corner. "One of the reasons they closed the programme was that they have a difficult time politically with the notion of providing subsidies for generating foreign investment," a US banker says.

While the programme ostensibly was open only to non-Mexican interests, some domestic companies got around this by arranging deals through Panamanian, Cayman, or Texan units.

Still others believe the programme was ditched because the government wanted the plan it preferred – the Morgan zero-interest bond plan – to have no competition. "The discount under the Morgan plan was more favourable to the government," says a Mexico City businesman. "The government didn't want any competition. They wanted to be the only game in town."

But the Ministry of Finance stoutly maintains that its payment of pesos to investors had the effect of bellows on last year's already high inflation. "Whenever I do a debt/equity swap I increase inflation," says Princeton-educated Foncerrada. "However, the impact on inflation was very hard to measure, depending on which sector the proceeds were used in and what they were used for."

But there is dissent from several quarters on whether the debt/equity deals are inflationary in the traditional sense – whether they contribute to higher wages and prices, or merely add plant, equipment, and jobs to a sluggish industrial base.

"Swapping debt for captial asset investment is not inflationary in the general sense," says an accountant, who has audited the books of Latin American companies for two decades. "These things are not raising prices that much. These are capital asset investments – they put money in the economy and people spend the money, but that's the only effect on inflation. In the meantime, debt that gets channelled into capital assets helps Mexico, because it gives people jobs. The swap window helped the country."

"This limbo period when the programme has been defunct has the effect of disallowing investment," says one banker. "Companies that might have invested here are weighing the lost opportunity

Foncerrada: tremendous pressure.

cost. This limbo time is hurting the country."

Some also think the Mexican government may be using the moratoriaum on debt/equity swaps as a means to put pressure on the country's lenders to grant further concessions in the next round of debt renegotiations. "The Mexicans are positioning themselves to reduce the debt burden and get more concessions out of the foreign banks," says the Latin American chief of an American bank.

For his part, Foncerrada is quick to refute some of these "reasons" for the swap programme's demise. "It is absolutely incorrect to say that the programme was suspended for political reasons," he insists. "First of all, the investment in Mexico made under the programme could not be used to buy existing industry. It could only be used for new investment. And a good part of the swaps were done by Mexican investors, either through the Caymans or Texas. A lot of times we knew who the investing group was, but we closed our eyes, as long as they covered all the legal aspects."

The reopening of the swap programme is linked to the country's policy toward its $105 billion foriegn debt, he says. The country needs to grow to make up a shortfall of millions of jobs. but it cannot grow as long as the debt service requires the transfer of nearly all the savings (except for a current $14.5 billion in reserves) needed for investment.

"We tried the Morgan deal in an effort to reduce the principal," Foncerrada says. "But we were not as successful as we would have liked. Now we are working on a new instrument that is similar but with refinements that will make it more successful."

If that doesn't work, Foncerrada says bluntly that Mexico will appeal to the international financial community for relief from at least half its annual debt service of about $9 billion, or a reduciton of $4 billion to $5 billion. "There is no time left. We have a fantastic social problem. The elections showed some of the effect of going six years with no growth, while real wages have fallen 50%. there is no time to explore new financial toys."

While he won't rule out the possibility that the debt/equity swaps could resume later this year, Foncerrada predicts there will be a new year and a new administration before the swap window reopens. And when it does, the plan probably will look substantially different. Here are some likely new features of the revised programme:

- The current annual inflation rate of about 30% (down from 159% last year due to the anti-inflation Solidarity Pact implemented in December) must be reduced to levels similar to other countries – in the 5% to 10% range. At this level, the government could pay the investing company in pesos, if it choses, without incurring excessive interest rates on borrowings to fund the swaps.
- There will be greater selectivity with regard to industries and regions that would qualify. "We would not choose projects such as hotels in Cancun or factories in Mexico City," Foncerrada says.
- Mexican interests would be openly included as direct participants.
- The programme would use an auction system similar to the one used in Chile. "The auction should increase the discounts on the deals, making a better deal for Mexico," Foncerrada says. "The demand for swaps has been very high, possibly $100 million a month. We see a total demand right now of about $4 billion


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Mexico has no time to explore new toys.

worth of projects."

●"We might be using bonds instead of cash to pay investors," he says. Bonds would allow projects to be funded by the market, not the government. And bonds could be denominated in a currency other than pesos, thus avoiding the impact of the likely interest differential between domestic Mexican debt and funds borrowed elsewhere.

In short, the Mexican government wants a better deal. They will reopen the swap programme once they have recreated it to be more market-oriented, without the subsidy that put a heavy drag on the country's budget at a time when it wanted to build reserves.

In the meantime, market forces are building which could well find other means to accomplish the same ends. "A lot of capital investment is waiting," says the accountant. "They'll find another way to do it. They'll do it by bank shots, so it's not so obvious."

One idea currently attracting notice is called "financial-partner financing." Under this plan, a foreign investor – typically a foreign bank that is a creditor to Mexico – would be paired with a Mexican company needing operating cash. The investor-creditor would provide cash in exchange for a short term (three to five years) equity position in the company.

At the end of that period, the Mexican company would repurchase the equity investment (which presumably would have appreciated in value) with funds made available through either a refinancing or a buyout. "There are many companies, typically medium-size firms, that right now, due to the Solidarity Pact, are strapped for cash," says Francisco Carillo a Mexico City attorney specialising in debt/equity deals. "If they cannot adjust their prices, they will not be able to continue.

"Now, if I am a foreign bank, a lender to Mexico, and I want to continue to be a lender to Mexico, or I am interested in converting my sovereign debt into equity, this plan offers me a chance to become an investor in Mexico with an equity exposure.

"We have no specific projects yet, but it is a promising idea being discussed by Mexican companies," Carillo says.

Debt swaps – Yes but who pays?

MoF Ferreira da Nóbrega shows no sign of clamping down on debt/equity swaps, despite Brazil's high inflation. But the discount on the debt can be expensive, for buyer or seller. By Bill Hieronymus

"Rice and beans" are on Rio's economic menu

A matter of hours after taking office as Finance Minister in early January, Mailson Ferreira da Nóbrega said Brazil's formal debt/equity swap rules had to be simplified. A few weeks later, he did just that.

Original creditors weren't pleased, but the overall reaction to the new rules has been enthusiastic. The Central Bank's estimate, sent to international creditors in late July, that the country is expected to convert $3.1 billion this year is seen as conservative. If there's any overriding worry, it's about Brazil's economic and political stability during the transition period under President José Sarney.

After Sarney objected that additional government expenses would be caused by the new constitution scheduled to be approved in September, he was upstaged

by an emotional speech by Ulysses Guimarães, president of the constituent assembly. The assembly's overwhelming vote of approval, followed by opinion polls showing the public disapproval of the President's speech, gave Sarney his biggest setback in three years of office.

The inflation figure for July of 24% – the second highest monthly figure on record in Brazil – released a few days later further weakened his position. Immediately speculation boiled in Brasilia that Sarney's fourth MoF in three years might be sacrificed in favour of new economic policies.

Nóbrega eschews the exotic economic policies of his three predecessors in the current civilian administration, insisting that the root cause of inflation is government over-spending. He has said he won't impose any temporarily effective inflation-control measures such as price freezes. His two immediate predecessors tried such programmes. Bankers are cheered that Nóbrega's common-sense economic policies, which he calls *feijão-comarroz* (beans with rice), will continue.

Already some respectable critics are saying the pace of debt conversions is too rapid for Brazil in view of the country's still uncontrolled public sector deficit. "In this scene, the formal and informal conversion of foreign debt into equity" is causing a strong pressure on the monetary base and having a huge influence on inflation, warns Alfonso Celso Pastore, a São Paulo economist and former Central Bank governor, who basically is in favour of debt conversion.

The government hasn't given any signs that it will back off from its current debt conversion programme, a main feature of which is the monthly auction of $150 million. However, it has stopped talking about implementing a new scheme of "debt-for-goods." Brazil's Central Bank governor Elmo de Araujo Camões told the Emresa Internacional de Comunicações (EmiCom) seminar in São Paulo on August 15 that the Central Bank has "about $10 billion worth of 'debt-for-goods' proposals [but] about 99% don't meet our objectives." He added that Brazil's merchandise, or visible, trade surplus was much better than expected and should be about $17 billion – a record

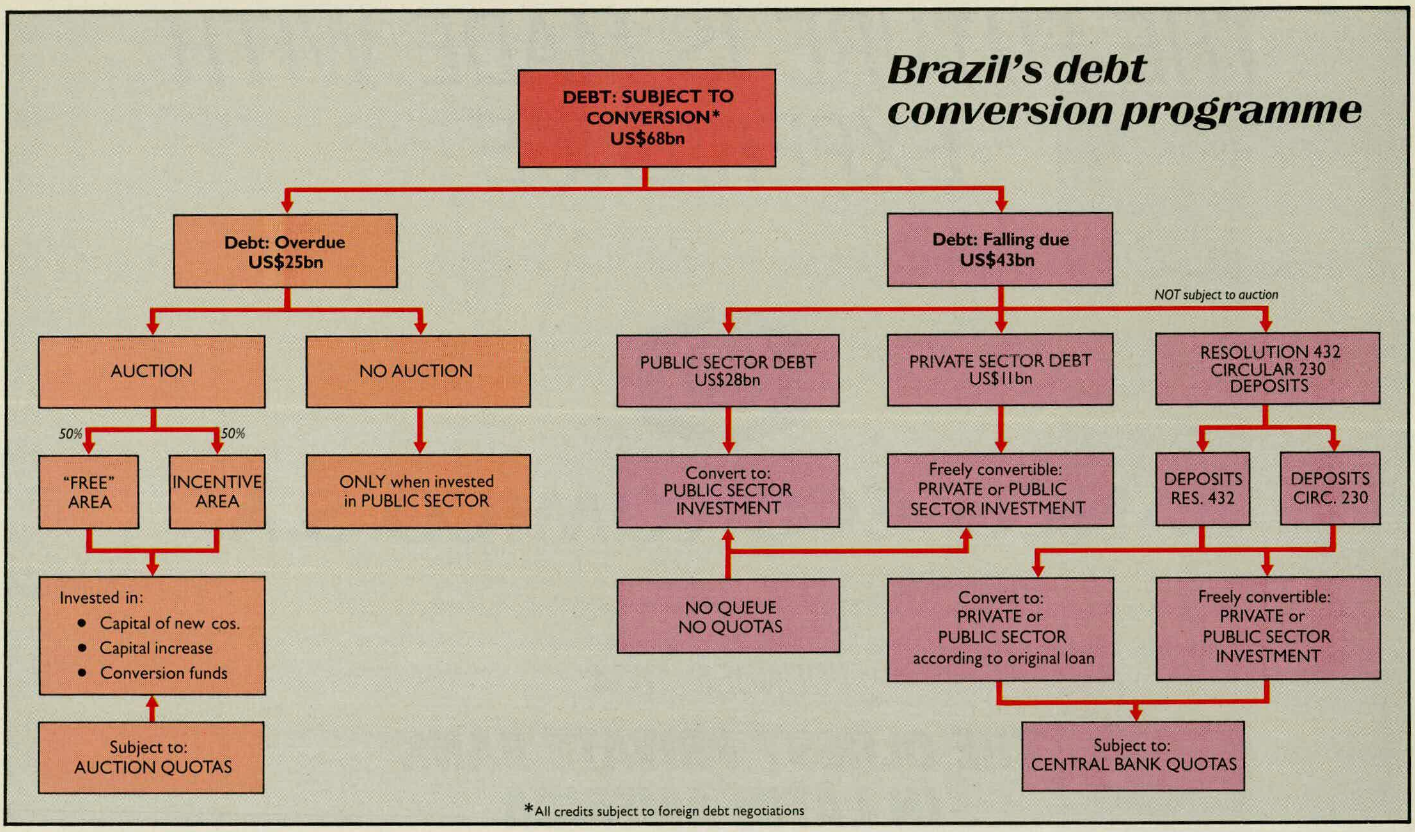
– instead of the $13 billion projected to foreign creditors. One reason for debt-for-goods was to stimulate exports. But exports are already setting records. The Central Bank is concerned that debt-for-goods will be used to replace existing exports already being made with cash payment.

Jordi Wiegerinck, assistant vice-president at Nederlandsche Middenstandsbank (NMB) in São Paulo, regards it as a good sign that the Central Bank didn't change the rules on debt swaps after the May monthly auction when the $75 million destined for the economically less advanced north and north east regions of the country was auctioned at a discount of only 0.5% from face value – not a good deal for Brazil. (In the monthly auctions, half of the $150 million can be invested anywhere, which usually means in the south-central industrial area of Brazil; the other half must be invested in the north and north-east.) "I believe the success of the programme is the continuity under Mailson da Nóbrega," observed Wiegerinck.

"The see-saw performance, as measured by the level of discount, can be explained by multinational companies' pent-up demand," said Jan R E Jarne, director of the international sector at Banco Itaú, a large São Paulo financial group. When the auctions started, in March, the multinationals had projects already defined. "By the third auction [May], this pent-up demand had been blown off. Brazilian corporations are still in the initial stages of analysing their investment plans."

He added: "I believe the conversion programme will be lasting, even though there are a lot of sceptics who don't believe it will." The banker boldly predicts "more Brazilian interest and foreign banks using their own portfolio".

Large international banks in São Paulo such as Crédit Lyonnais, Citibank and Chase, say it isn't interesting for them to convert at discount in the auctions because they lent the funds to Brazil at 100% face value. In a comment that characterises the view of several creditors, William Dorson, head of Chase's capital markets group in São Paulo, says, "Chase brought over $2 billion into Brazil.



We would like to be paid that amount. We feel that we are being prejudiced [by the rules]"

He notes, however, that the rules make financing viable for a multinational, which can buy the Brazilian debt on the New York secondary market for, say, 53% of face value. The multinational profits from the difference between the 53% it pays and the government's auction price, which, for example, was 73% (after a 27% discount) in the 5th monthly foreign-debt auction on July 28 in Belo Horizonte.

Chase, like other original creditors unhappy with the discount, is doing a booming business as an intermediary. This is readily observable when a reporter visits the bank's corporate banking office in the old financial district in São Paulo. At a little before 6 pm, when many local banking offices are vacant, the Chase São Paulo office is buzzing with phone calls and bankers discussing deals. "It is a very profitable business," says Dorson.

"There is one problem for Brazil's creditors" with the debt conversion rules, First National Bank of Boston's Economics Department said in its Newsletter Brazil at mid-year. The rules "don't differentiate between primary and secondary lenders. Thus the same discount applies to a loan originally made by a bank and a loan purchased from another financial institution at well below face value." The true winners in the monthly auction are the companies that buy – which enjoy lower investment costs – and Brazil – which reduces its foreign debt.

Similar sentiments are voiced by António M Boralli, vice-president, Citicorp Investment Bank in São Paulo, who says his institution isn't keen on converting its own $4.6 billion in Euroloans to Brazil at a big discount. "This isn't interesting to us because we loaned the funds to Brazil at 100% face value."

Nevertheless, there's growing speculation that the large original creditors could start converting some of their own credits, following the lead of Manufacturers Hanover Trust. However, the success of Nóbrega in quickly making peace with international creditors only seven months into office is likely to make some institutions prefer to remain creditors and not become equity investors.

"The re-approximation of Brazil with the banks and the International Monetary Fund discourages innovative decisions with debt conversion. With more security, the banks prefer to continue as creditors, and not become investors," says Paul L Bydalek, managing partner of Atlantic Capital Consultoria Financeira, in Rio de Janeiro.

Salomon Brothers and Atlantic Capital put together a deal for the conversion of $50 million of foreign-bank debt into capital of Brasmotor, a São Paulo white-goods maker. Participants included: Banco Exterior de España – $10 million; Barclays Bank – $10 million; Canadian Imperial Bank of Commerce – $15 million; National Bank of Canada – $5 million; and Bank of Nova Scotia – $10 million.

The transaction for Brasmotor is among the best debt/equity deals of the year. Bankers again and again, when asked to name the best deals of the year, said: "Those made under the old rules" – meaning before debt conversion was suspended in July of 1987. The less attractive deals are those made under the new rules in force this year, with debt that's matured, which is on deposit at the Central Bank being discounted at a rate set by the monthly auctions.

While the Brasmotor deal was completed this year, it was proposed under the old rules in July 1987; hence no discount. The deal would've been impossible under the current rules with the discount, Bydalek claims.

Another so-called "best deal" debt conversion is the $200 million equity of Autolatina taken by Chase Manhattan's Capital Markets Group. Autolatina, the holding company for the Brazilian and Argentine subsidiaries of Volkswagen and Ford Motor, says the $200 million is part of the $250 million to $300 million the company plans to invest in Brazil.

However, the São Paulo financial has doubts that the deal is a swap for equity. "It's a loan dressed up as an equity investment," said one corporate finance specialist. "There must be some assurance outside Brazil that Chase in the future will be repaid in dollars. Look at the recent performance and prospects for Autolatina." In 1987, Autolatina reported a net loss of $377.5 million.

Perhaps the worst deal was of Corretora FNC, the Brazilian brokerage afiliate of Citibank, for the Japanese television maker Sanyo where the discount was 32% on the debt bid in the April monthly auction for Sanyo's investment in Brazil. "They [Sanyo] accepted the 32% discount for $36 million to be invested in Brazil because they are looking at the long run," commented one banker on the transaction.

Japanese banks have had to sit on the sidelines of the buzzing debt/equity business, according to Takuji Iwaksaki, executive director of Banco de Investimento América do Sul, a São Paulo-based affiliate of Japan's Fuji Bank. This is because of conservative Japanese accounting rules and the need to get approval simultaneously from the Japanese Finance Ministry and Brazil's Central Bank.

"It's a bit difficult for us as we have a close relationship [in Brazil] with subsidiaries of Japanese companies," says Iwasaki. He predicts that some new

Hilario Paulino Neto: "For minerals, it's the wrong moment to invest."

flexibility might be forthcoming soon from Tokyo.

The Japanese government recently announced that it will not tax gains realised in debt swaps by Japanese corporations. Japan hopes thus to encourage the conversion of debt into equity. The signs are that the US Internal Revenue Service is unlikely to give a similar concession to US corporations.

The Japanese aren't the only potential players waiting in the wings. Others are put off by measures such as the approved – but not yet enacted – requirement that foreign-owned mining companies in Brazil must be majority-owned by Brazilian companies. "Clients are waiting for better conditions to invest," says Samuel Bosch, representative in Brazil for Banco Rio de la Plata, an Argentine bank active in other Latin American debt swaps but so far in no Brazilian ones. He cites uncertainties created by anti-business measures drafted by the constituent assembly.

However, Banco Crefisul de Investimento's executive director, international division, Hilario Paulino Neto, cautions: "An investor should be concerned with what is happening to Brazil, not the constitution."

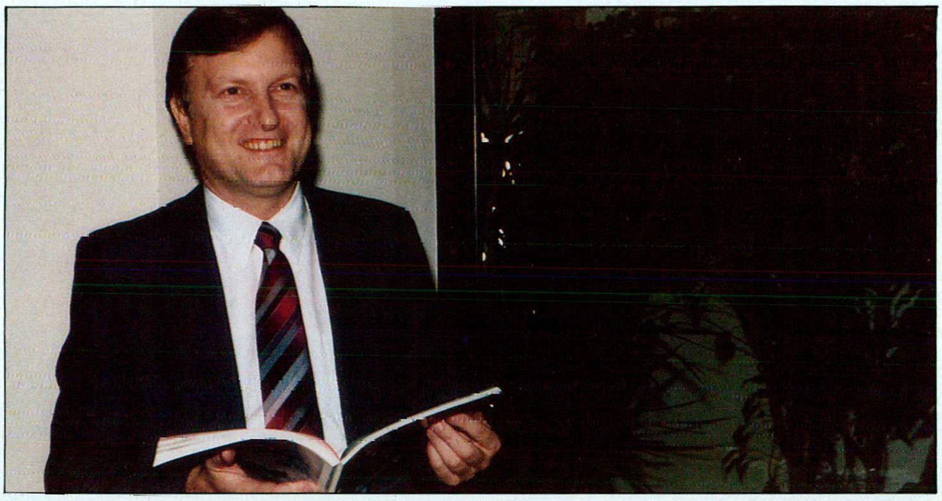
Crefisul, an affiliate of Citibank, is studying a flood of projects to marry foreign bank credits to Brazilian equity investments. "We are analysing good projects that aren't multinationals," says Crefisul's Frank Tang. Paulino adds: "We

Resende: "The hour to invest is now."

have to have a project that makes sense to the foreign investor. The [local] investor is looking for a project to capture the discount. However, the foreign creditor is looking for a 'workout' of his loan." Currently Crefisul has three mandates to convert foreign debt into equity and other proposals that may soon become mandates.

"There is a certain caution because of the constituent [assembly], but Brazil is bigger than the constituent," asserts Unibanco-Bancos de Investimento do Brasil director, Luiz Fernando Azevedo Resende. "The hour to invest [in Brazil] is now" when the economy isn't going well.

As an example, he cites a debt conversion Unibanco made for Club Méditerranée, the French resort company. The debt swap is for investments in a new Club Méditerranée resort near Rio de Janeiro. Unibanco, which is 10% owned by Japan's Dai-Ichi Kangyo Bank, "is looking for investors for $13.5 million" for debt to be invested in the $30 million resort.


Gordon Butland at Multiplic Banco de Investimento

The constituent assembly takes a terrific pounding from the local press, but it has its defenders. Among them is Roberto Teixeira da Costa, president of Brasilpar Serviços Financeiros, a São Paulo intermediation and financial consulting firm. Critics "want the constituent to reflect the attitudes of the elite, of which

I am a part," says the former chairman of Brazil's Securities Commission. "This is wishful thinking."

A beaming Teixera da Costa told *Euromoney*: "We have just completed an \$85.5 million financing" to create Brazil's first venture capital firm. Some \$80 million came from a private placement arranged by Banque Paribas and Brasilpar through debt conversion. The new firm, called Equitypar, is making investments in medium-to-large Brazilian companies.

Gordon Butland, director of corporate finance at Multiplic Banco de Investimento (an affiliate of Lloyds Bank), says: "It doesn't matter what happens in the constituent. Look at Aracruz Celulose. Its investment is \$1 billion in paper and pulp projects." The current political uncertainty doesn't weigh heavily when "you're talking about a long-term project such as trees."

International specialists have noted that Brazil has a large advantage when it comes to producing pulp and paper. Trees are ripe for harvest in a fraction of time needed in traditional northern hemisphere climates. Pulp and paper projects are thus key areas of interest for debt-to-equity swaps by foreign banks, Multiplic's brokerage unit has handled Manufacturers Hanover's aggressive swaps of debt for investments in Brazil's pulp and paper industry in the June and July monthly foreign debt auctions.

Butland, a 48-year-old Briton who has spent most of his adult life in finance in Brazil, is radiant about the future for debt swaps in Brazil: "I think we have only started on debt conversions." Multiplic is working on the "first East European debt conversion." The project involves a Hungarian irrigation project in the north east.

Butland worries more about how to carry out the debt swaps in Brazil's fast-moving, high-inflation environment. "The taxation aspect must be closely looked at to avoid taxes on inflationary profits. You should only bring in money on the last days of the month." In a nutshell, if funds are brought in at the beginning of the month and parked in overnight funds, they'll earn inflationary profits for the month – and be taxed accordingly.

"You only learn this when you've been

Manufacturers bids for its own loans

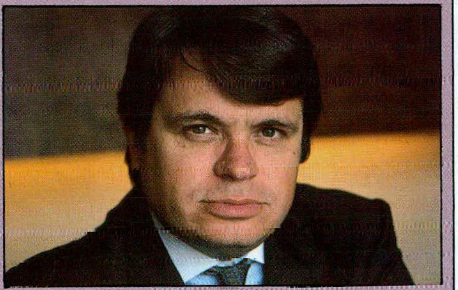
Manufacturers Hanover Trust, breaking ranks with other large creditors to Brazil, is converting its own loans to the nation into equity investments.

"This is the first time a creditor bank has bid for its own loans," said Wiener Rouzeau, Manufacturers Hanover vice-president, immediately after the frenetic bidding at the June 28 debt auction on the São Paulo stock exchange. Acting through the brokerage unit of local investment bank Multiplic, Manufacturers was the surprise taker of \$50.4 million of the \$150 million auctioned.

"These [successful bids] are 100% from our own loan portfolio to Brazil," Rouzeau says. In what could be taken as a dig at other banks that are in the debt-swap business solely to earn fat commissions, he adds: "Our bids are for investment in Brazil, not speculation." Rouzeau was also spotted at the July auction, where Manufacturers took rights to convert \$19.5 million into equity. The average discount at the June auction was 14.75% off face value; the figure for the July auction, which was held at the small stock exchange in the interior city of Belo Horizonte, was 11% off face value.

Fulvio Dobrich, a Manufacturers' senior vice-president, says debt/equity swaps have the potential for a return that will more than compensate for the 15% discount. "All of our investments thus far have been in the paper sector," in non-voting, preferred shares of Companhia Suzano e Papel e Celulose, a São Paulo-based producer of cellulose, paper and cardboard.

Dobrich confirms that the bank is negotiating to swap some of its foreign debt for shares in Ripasa SA Celulose e Papel, another large Brazilian producer and exporter of paper and cellulose. Until now, both companies have been 100% Brazilian-owned. Sources in São Paulo cite a figure of \$30 million for the debt Manufacturers is negotiating to swap for shares in Ripasa.


Dobrich – investment in paper

Dobrich also confirms the rumour that the bank is negotiating to set up an investment bank in Brazil. "Our leasing company [in Brazil] is too limited for our \$1.7 billion," in loans to the nation. Investment banks in Brazil, while they are not allowed to have majority foreign control, have broad flexibility to work in the local financial markets, and have stock underwriting, brokerage and leasing subsidiaries.

Dobrich wouldn't confirm reports that the bank plans to convert between \$150 million and \$200 million of its own loans to Brazil into equity investments in the nation within a 12-month period.

"We plan to be in Brazil for a long time," Dobrich says. Unlike other large creditors to Brazil such as Lloyds Bank, Chase, Citibank or Bank of Tokyo, Manufacturers doesn't have commercial branches in the nation. Dobrich admitted that this lack of "on-ground" presence in Brazil, except for a leasing company subsidiary, puts the bank at a disadvantage in staffing to follow the new investments.

Dobrich said in a June interview that the bank, through its debt swaps, is trading loans from the public sector to the private sector to get a better return. Both Suzano, where the investments have already been made, and Ripasa, being negotiated, are regarded as well-managed companies – in a sector in which Brazil has special advantages.

Jari pulp mill: the industry is a key target for debt swaps

hit on the head with it," says Butland, remembering a recent case painfully. With Brazilian overnight funds paying about *1% a day*, a mistake on when to bring in the conversion of a multi-million investment suddenly involves huge sums.

Butland also refers to the "cultural shock" banks interested in converting debt into equity experience when they start trying to understand monetary correction – Brazil's system of adjusting prices, financial instruments, balance sheets, wages and other payments for inflation.

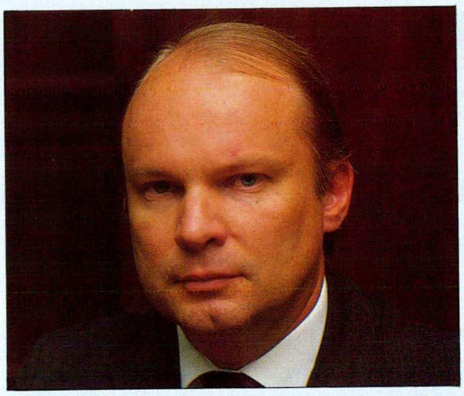
Bankers' estimates of the amount of foreign debt Brazil will convert this year are far above the $3.1 billion official government estimate. "I'd say $4 billion to $5 billion for the year," says Wiegerinck at NMB. "There will be some $1.7 billion in formal conversion, but informal conversions easily will be $2-$3 billion or maybe $4 billion for all of the year."

Formal conversion includes swaps made

under the monthly auction scheme as well as deals made under the pre-July 1987 rules. It involves debt that's already mature, totalling about $25 billion available for conversion.

Informal conversion is made for debt that hasn't matured, but is about to fall due. There's a total of some $43 billion of such debt – $28 billion of it public sector debt that must be converted to public sector equity.

The new business of evaluating swaps and investments requires a different type of banker, or perhaps an individual who isn't a typical commercial banker. "I don't think there are any commercial bankers left. We are all investment bankers," says Michael Viadero, who heads corporate finance for First National Bank of Chicago in São Paulo. First Chicago is looking at the ticker in its debt-swap programme. "We have a corporate objective at First Chicago. We want to manage our troubled-country debt to a level where the capital markets don't penalise our stock price," says Frank C Schell, vice-president and representative for First Chicago in São Paulo. "We want to bring down the total of $3.2 billion to $2 billion by the end of next year." The bank had $745 million in loans to Brazil at the end of 1987.

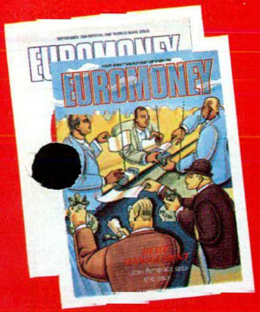


Jarne: more conversion

Like other original creditors, Schell admits: "Our asset position puts us at a disadvantage in comparison to manufacturing companies that can pick up at a discount on the secondary market." First Chicago's own accounting rules prohibit it from swapping much of its own debt unless the discount from face value becomes quite narrow.

The overwhelming vote is that the Brazilian debt–equity programme will stay. "We will see more conversion than Brazil has ever had in direct foreign investments," says Banco Itaú's Jarne, who foresees debt/equity swaps this year exceeding the official $3.1 billion estimate.

Next year, Brazil should have even more reason for more swaps. The country's new preliminary agreement with the private banks provides that a year after signing, the institutions can convert up to $50 million of the new money they supplied a month. And, the $50 million monthly can be converted at par, without any discount.



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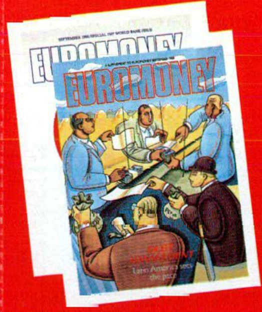

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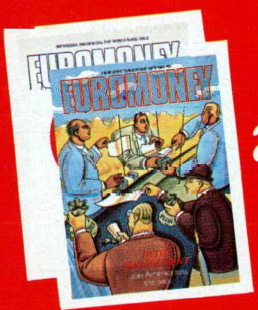

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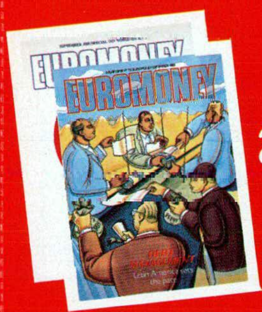

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Lots of twinkle – few stars

After a jittery start, Argentina's debt/equity swap programme is up and running. Though still quite small-scale, there have been some surprises – not least the weak presence of the big US banks.
By Judith Evans

The debt/equity programme: a landmark in Argentina's banking history.

Argentina launched its debt/equity swap programme on January 30 after more than a year of intense debate. In the middle of the southern hemisphere's steamy summer heat, project representatives crowded into the appointed meeting room of the central bank in Buenos Aires for the first public auction.

In the tense atmosphere they briefly forgot their resentment at the vast majority of financial circle members who were happily swapping nothing more serious than rumours and gossip on the beaches and in the bars. "You feel like a bunch of high school kids waiting for the school principal to announce exam scores," recalls one bidder. And in the tiny circle, where everyone knows everyone, those who miss the call or have their project bids returned feel a bit like they've been sent back to the second eleven.

Two more auctions have been held since January. While the anxiety remains high, there is relief throughout the financial sector at the functioning of the programme.

But not everyone is satisfied. Alejandro Reynal, partner in Shaw, Reynal and Bustamante, a local M&A group, describes the Argentine programme as "swapping a la criolla". Argentina, he laments, has managed once again to take an excellent idea and mould it to its own anti-investment culture. "No one has changed their thinking from sovereign risk to business risk," he says.

While many, especially those connected to major creditor banks, agree, there are others who argue that the programme is on track. Debora Giorgi, an economist with Gonzalez Fraga Macroeconomia, says that capitalisation is "helping investors overcome the Argentine risk factor". Gonzalo Peres Moore, a member of the Banco Rio team that has the lead in the number and value of projects accepted, said that the great value of the swap programme lies in switching subsidies from obscurity to transparency, no small achievement in a country where the cost of regional promotion schemes is a matter of conjecture.

The subsidy, or rate of discount has turned out to be an interesting aspect of the programme. Thanks to the heavy competition for small quota amounts, the subsidy has dropped dramatically in the first three rounds. In January's auction the average was 97.8% while by June it had fallen to 56.8%. Peres Moore points out that, ironically, the government gave up its early demand for a one-to-one clause only to find that now, with pure market forces operating, it is getting two additional dollars for every one that is converted.

The programme is small though. Totalling the first three auctions, $343 million in foreign debt was cancelled and $427 million was committed to investments. The bi-monthly auctions are set at $50 million of effective conversion value, a target that the government intends to maintain over the next five years. Economic ministry officials set the quotas with emission fears in mind. Given that inflation is currently averaging 20% a month, it's hard to fault their caution. In fact, two former economics ministers, Jose Maria Dagnino Paxtora and Roberta Alemann have recently questioned the programme on the grounds of its potential for creating additional monetary pressures.

But the modest quotas are only part of the reason that debt/equity swapping is limited. The idea was never regarded with much enthusiasm among the opposition Peronist Party, or within the government's own Radical Party, for that matter. Although not openly stated, some of the features of the programme, especially the special sub-limit within the total auction quota for small and medium-sized domestic companies, were included to smooth ruffled political feathers.

One of the factors that economic policy secretary Juan Sommer cites as a reason for his being pleased with the programme is the high level of participation for small projects. Of the 36 projects approved, 20 had an average cost of $1.8 million.

As a result of the Argentine debt/equity programme's being moulded to what the authorities perceived as both political and economic realities, it has created an investment firmament with lots of twinkle but few stars. It hasn't, however, been without surprises. Most unexpected was the weak presence of the big US banks. Chase Manhattan, Morgan, Manufacturers Hanover, Irving, and Bank of America all won successful bids but for only one project each. Eleven local banks, on the other hand, had the four largest projects and accounted for 31 of the 36 winning bids.

Policy secretary Juan Sommer

President Raul Alfonsin

Even more bewildering was Citibank's absence from the roster, given that it was capitalisation's most forceful advocate. Only last May, Citicorp president John Reed, on a visit to Buenos Aires, reiterated his organisation's pro-swap position to president Raul Alfonsin and economics minister Juan Souraoville. The banker's candidness is rumoured to have dropped Citibank-government relations into an Antarctic temperature range.

What happened to the "A" team? Pablo Taussig of the Banco Frances del Rio de La Plata says that over a year ago when the programme was being debated and designed, the big banks wanted it. "But," he adds, "they didn't expect the value of Argentine debt paper to fall so far." Now that the secondary market price is stuck at about 25 cents on the dollar, the loss is too great, even for banks that have reserved. The head of a respected local investment bank seconded this view. "Reserving is one thing and writing off is another; at the current price there aren't many banks who are going to sell – to say nothing of take equity."

And only one did: Manufacturers Hanover. Representing Massuh SA in its bid for a $20 million expansion of a pulp and paper plant in the industrial suburb of Quilmes, Manufacturers took 6% in stock. It was a complicated deal to work out, one that lawyers and bankers cut their teeth on as they broke new ground seeking approvals from the Argentine Securities and Exchange Commission, the stock exchange and the swap authorities.

They also gritted their teeth when what one observer called "a professional stockholder trouble-maker" threatened to torpedo the whole deal. Adrian Hope, partner in Cardenas, Hope & Otaro Monsegur, the firm that did the legal work, concluded that in the final outcome both sides got a good deal. Manufacturers Hanover got 52% nominal value on its debt and Massuh got the injection of capital that it needed.

Without question, the highlight of the first three auctions was a swap made by Swift-Armour SA, a division of Campbell Soup Co. Not only was it the biggest but it also came in right on the money with its discount bid of 35.25 cents on the dollar, giving it the best over-all gain. Local company president, Carlos Oliva Funes, said that he trusted his "smell" choosing the magic number, not even telling the Banco Rio team until the moment of the bid.

The Swift deal also won a true insiders' sweepstake; it was kept a secret in a clubby environment where that is a major and respected feat. "We had to," explains Oliva Funes, "because the quotas are so small we knew that we could easily get shut out if we bid wrong."

Swift bid right and capitalised $40.7 million, or 57.5% of a $70.9 million project, in debt, soaking up 75% of the limit for the first bidding round. Banco Rio, in this case, acted as intermediary bank, as required by the programme's guidelines, and provided its own debt paper, taking preferred stock as equity.

In some subtle way, Swift's capitalisation coup has given the programme a seal of approval. The company is a household word in Argentine, where it began in 1907 as La Plata Cold Storage, and, although now owned by a US firm, it has at times been in local hands, including those of the state. It's as close to being thought of as a domestic firm as a multinational can be.

The company has gone through a major revamping since it was returned to private hands in 1977. Its reorganisation, which required an investment of $4.5 million dollars seems to be paying off. In 1987 Swift was the lead meat and meat product exporter in Argentina with gross sales of $132 million and exports of $95.9 million. To consolidate its expansion in 1985, Swift began planning the building of a high-tech meat processing plant in Rosario. The feasibility studies and engineering plans were finished just in time, recalled Oliva Funes, the 45-year-old University of California, Berkeley, graduate, to be the first firm to submit a debt/equity project for evaluation.

The future of Argentina's programme is as controversial as was its initiation. In May, new regulations were announced that will permit the capitalisation of on-lending and state bank credit lines, also called rediscounts. Full central bank information on how this will work has not yet been published and no one is quite sure how this form of debt cancellation will function. On the one hand some fear that it is simply a way to keep politically well-connected but financially bankrupt companies afloat. Others agree with Jorg Gonzalez, who up to last year was a member of Argentina's debt negotiating team and is now a partner in a new up-scale consulting firm Aguirre, Gonzalez, Peirano Associates, who said that the non-emission creating debt cancellation "is the cheapest method to clear-up old mistakes".

Eleven local banks have taken the lion's share of the winning bids.

Another change came in June when it was announced that projects of over $20 million can now be treated outside the bi-monthly amounts as advances against future quotas. While this has the appearance of amplifying the programme other measures have restricted it. For example, projects that receive any other kind of promotional benefit are ineligible for debt/equity swapping and value added tax must be deducted from the project costs.

These new regulations have confused those who are convinced that still greater flexibility in the future is inevitable. "I find it difficult to say there is a clear direction for the programme's future," concluded Alejandro Reynal.

This announcement appears as a matter of record only

Gas del Estado
Sociedad del Estado

Yacimientos Petroliferos Fiscales
Sociedad del Estado

U.S. $120,000,000
Pre-Export Financing Facility

Guaranteed by
The Republic of Argentina

The undersigned acted as agent, co arranger, co-lead manager and lender for this facility
The Chase Manhattan Bank, N.A.

CHASE

Eurodollar Loan Syndication

This announcement appears as a matter of record only

plásticos
del lago c.a.

A private Venezuelan company producing high density polyethylene, at the El Tablazo petrochemical complex

Debt Reprogramming
- US $39,000,000 Eurodollar Loan
- FF 86,000,000 French Buyer Credit Facility
- BF 202,000,000 Belgian Buyer Credit Facility

The undersigned acted as financial advisor to Plasticos del Lago C.A. in relation to the restructuring of the Company's foreign debt
Chase Manhattan
Capital Markets Corporation

CHASE

Project Finance

This announcement appears as a matter of record only

Guilford Mills Incorporated

$2,400,000
Mexico Debt Equity Capitalization

Arranged by
Chase Manhattan Capital Markets Corporation
The Chase Manhattan Bank, N.A. Atlanta Regional Office

CHASE

Debt/Equity Conversion

SOC. PESQUERA GUANAYE

U.F. 180,000

FINANCIAMIENTO DE MEDIANO PLAZO
COLOCACION PRIVADA DE FONDOS

AGENTE:
Inversiones Chase Manhattan Ltda.

CHASE

Commercial Paper

This announcement appears as a matter of record only

Industrias Forestales S.A.

US $37,873,038.27
Aumento de Capital
Equivalente A $7,700,265,043

Bajo Normas del Capitulo XVIII,
Anexo 4, del Compendio de
Cambios Internacionales

Agente
Inversiones Chase Manhattan Ltda.

CHASE

Equity Private Placement

PROMETAL
Produtos Metalúrgicos S.A., São Paulo
has gained control of the
Buritirama Ore Body in the Carajas Region of Brazil
which has been acquired from
Mineração Colorado Ltda.
a wholly-owned subsidiary of
Utah International Inc., San Francisco.
The undersigned assisted in negotiations and acted as financial advisor to Prometal
Chase Manhattan
Capital Markets Corporation

CHASE

M & A

This announcement appears as a matter of record only

SUCASA

Sociedad Urbanizadora del Caribe, S.A.

U.S. $7,000,000
Collateralized Bond Issue
10% U.S. Dollar Bonds, Due 2001

Agent and Servicing Bank
The Chase Manhattan Bank N.A

The undersigned acted as arranger and underwriter to Sociedad Urbanizadora del Caribe S.A
Chase Investment Bank (Panama), S.A.

CHASE

Debt Private Placement

This announcement appears as a matter of record only

plásticos
del lago c.a.

A private Venezuelan company producing high density polyethylene, at the El Tablazo petrochemical complex

$34,544,955
Interest Exchange Cap

Initiated and arranged by
The Chase Manhattan Bank, N.A.

CHASE

Interest Rate Cap

This announcement appears as a matter of record only

Río Colorado
COMPAÑIA DE PERFORACIONES RIO COLORADO S.A.

U.S. $40,000,000

The undersigned acted as financial advisor to Rio Colorado and arranged its debt cancellation
Chase Manhattan
Capital Markets Corporation

CHASE

Financial Advisory

CHASE

Deal of the year

They may not find it as easy as falling off a log, but debt/equity specialists in Chile have made good use of the country's forests.
By Imogen Mark

After three years, $1.1 billion in debt/equity business has been done under Chapter 19 of the foreign exchange regulations, of Chile's central bank. The bank officials and brokers who handle the business now have plenty of experience in classic debt-for-acquisition transactions.

The future will be in what one broker calls "Project 19". That means the variants of debt-for-debt swaps to provide working capital for new acquisitions – a process which will be helped by planned modifications in Chile's overall agreement with its creditor banks, which will allow greater scope for debt prepayment..

Unofficially, some sizeable transactions have already been done, especially back in 1986, before the central bank moved to close one gaping loophole in its regulations. Prepayments have gone on since then and public sector companies such as the (now-privatised) steel company, CAP, as well as some big private sector players, have been quietly clearing off some foreign currency commitments while they were flush with pesos.

But the finance ministry has not decided how it will handle this kind of transaction, so the new regulations have yet to be drafted. Quite a few bankers and brokers have been jotting down their own helpful suggestions on the backs of envelopes, ready to be produced for the central bank's assistance. But once the regulations are in place a number of deals will be ready to go.

These are the deals of the future. For the moment, though, the measuring stick for the "deal of the year" is size rather than inventiveness. So the 1988 title goes to the three-way venture into the pulp business by the Anglo-Dutch oil company Shell, Scott Paper of the US, and Citibank. The total investment by the three companies under Chapter 19 is $277 million – the biggest single debt swap operation yet done.

The three partners are paying an on-paper price of $120.5 million for a half-finished pulp plant in the main forestry region around Concepcion. The plant has a tangled history of debt and mismanagement, and the Banco Exterior de España, the main creditor, retained the services of Morgan Guaranty's Chile office to handle the bidding (which took place at the end of March), and give the proceedings proper seriousness.

The new partners will spend up to $200 million more in redesigning and expanding the plant to produce eucalyptus rather than pine pulp. And they are also paying $65 million for a stand of timber to supply the factory during its first five years of operation. Their total investment will reach $450 million, according to David Turner, president of the new company, Forestal e Industrial Santa Fe.

On paper, they are paying a steepish price for the privilege of joining the exclusive club of local pulp-makers (two at present). But banking sources estimate that Shell, for example, which is taking the majority stake (60%), will probably buy paper for a face value of around $180 million, for a $160 million investment, and will end up paying about $110 million for its share. Chile's debt is trading fairly steadily at a discount of 40% of face value.

Shell has handled three small Chapter 19 transactions already, using its own financial staff and getting local banks to bid for the business of arranging the debt purchasing and redenomination contracts. This time, though, explains financial director Rod Stead, they felt the deal was just too big to handle that way, so they

brought in one of the main specialist consultancies, Asset-Chile, to advise them on the debt purchasing side of the deal.

Stead thought originally it might be difficult to find the amount of paper they needed, but in the event it was remarkably easy. "It all worked beautifully," says David Gallagher of Asset-Chile, one of the two partners in the agency.

"A deal like this lends itself to buying whole portfolios of Chilean paper," he says, "and since we were the only buyers in the market at that moment we just sat back and waited for people to ring. We got offered what we wanted several times

The trees which grow so fast in Chile help the debt/equity deals of Santiago.

over, so we could pick and choose."

One reason why there was no shortage of paper, says Gallagher, was that "Banks who were not on anyone's list of sellers six months ago were in the market."

The central bank gave the transaction high priority because of its size. Indeed, they let it be known before the bidding for the plant took place that permission would be available in principle for a Chapter 19 operation if the new owner chose to use the mechanism. So Shell and Scott were able to go ahead and buy options for the paper they needed, conditional on final central bank approval, as soon as they knew they had won the bidding.

About half the total package of titles consisted of bits and pieces of debt, so this was handled through a warehousing deal with Lazard Brothers. The London bank's job was to buy the paper in its own name against a commitment from Shell to buy back at the same price. Lazard held the debt, re-packaged it, dealt with the secondary swaps to get the package into the right shape (earning a fee in the process), and had it ready to hand over when Central Bank approval was given.

The attraction for Lazards was the interest it could earn on debt bought at a 40% discount paying a full 100%. Citibank handled its own business on this occasion as well as in the other debt/equity investments it has made. It now has $14 million worth of a silver and gold mine (together with Shell and a Canadian mining company, Westfield Minerals), and another $26 million in a stand of timber, Bosques Copihue, plus Chapter 19 investments of $60 million for the new pulp plant and $18 million for a share in a board factory in the pipeline. It expects to do another $42 million worth of investments by the end of the year.

Advancing with Decree 1988

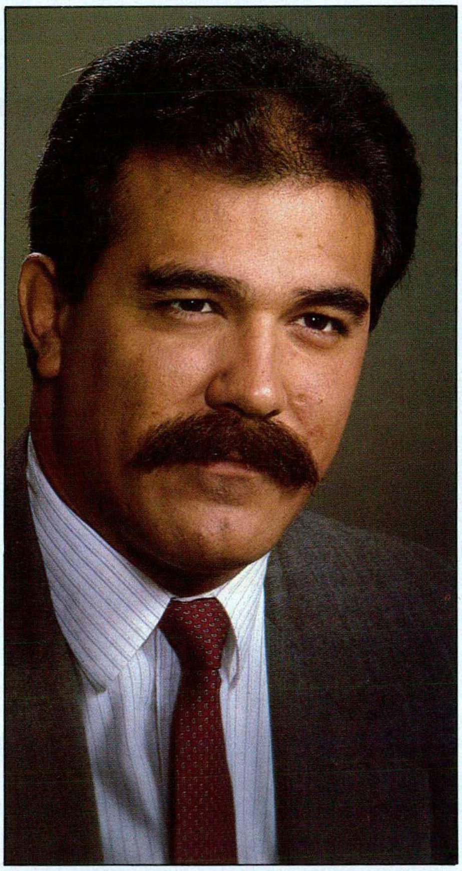
New proposals could give a much-needed boost to Venezuela's debt-for-equity programme, reports Judith Evans

Venezuela's debt/equity swap programme has been stumbling. With the millstone of an unrealistic exchange rate weighing it down, the programme was on the verge of sinking into oblivion while it awaited adjustments, presumably to be made after the December presidential election. With bolivars trading in the open market at over 40 to the dollar, the programme's rate was fixed at 14.50. "I saw no ray of hope on the rate and so I gave up on debt/equity swapping six months ago," says the representative of a US bank that has been an active swapper in other countries.

But that may all be changing very soon. Juan Carlos Perez-Segnini, head of the Superintendency of Foreign Investment (SIEX), says that at the end of July, authorities, including President Jaime Lusinchi, agreed to allow conversions at the free market rate for "Export Investment Decree 1988". This about-face has not been officially announced yet but when — and if — it is, it could lift the programme out of the doldrums.

But there is likely to be a trade-off. Members of the debt/equity approval committee — officials from the Ministries of Finance and Development, the president of the Central Bank and the head of SIEX — will reduce the portion of a project that can be financed by debt conversions. The question is by how much. Currently, only the large projects regulated in Decree 1988 have limits. For investments of less than $100 million, 50% of the total can be financed by capitalising debt; for projects of over $100 million the eligible portion was raised to 80%. This is likely to be reduced to 40% and 60%.

It isn't clear how this will affect other provisions of the programme that are tied to the 14.50 official exchange rate, such as capital exports and overseas income to cover local operating costs. Nor is it clear how the bankers and businessmen who championed a conversion plan will react to this tit-for-tat, although some analysts assume that informal consultations have taken place.



Perez-Segnini: "We're at the onset of another wave."

Important as removing the exchange rate strait-jacket would be, it is not the overall programme's only constraint. A chorus of bankers and economic analysts say that it will be some time after the elections before the programme's fate will be known.

The Venezuelan debt conversion plan, in an attempt to incorporate the best features of all the existing Latin American programmes, includes three separate programmes, each directed at different targets. The least talked about is the private foreign debt capitalisation programme which seeks to chip away at the $5 billion owed abroad by Venezuelan firms. Perez-Segnini reports that over 45 operations have so far been completed, converting $120 million in debt through stock issue expansions.

Under debt-for-equity swapping, there are two programmes: an umbrella programme under Decrees 1200 and 1521 and the "Exports for Investment" programme governed by Decree 1988. It is the latter that is slated to be slicked up by a new free market exchange rate agreement.

The special export incentive plan applies only to projects that are designed to sell 80% of their production abroad and targets specific sectors including metals, petrochemicals, paper and pulp and mining. The initial plan basically covers all other projects.

As of August, according to Perez-Segnini, eight projects have passed the first authorisation hurdle and six have been presented and are pending approval. In addition, there are a handful of projects that are in the "pre-qualified" state, most of them Decree 1988 mega-investments in aluminium, steel and petro-chemicals. No project has yet reached the stage where the final exchange of debt paper for bolivars takes place, so no rate has been written in concrete. And that may not be accidental.

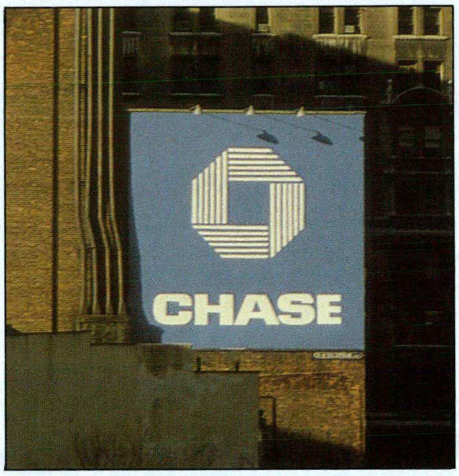
The most advanced project is a debt-for-preferred stock deal between Chase Manhattan and Vencemos Cement, a major Venezuelan cement producer owned by the powerful Mendoza Group. The $41.4 million project was approved in May of this year. Chase is planning to swap debt paper from its own portfolio for a still undetermined amount of preferred stock, with, insiders report, a buy-back guarantee. If this turns out to be the case, the Vencemos deal is a debt capitalisation temporarily disguised as a debt/equity swap, a formula that Chase is also thought to be using in Argentina.

Although Chase officials will not confirm it, government sources claim that they will subscribe to 20% of the stock emission, after initially considering absorbing the full issue. Bankers speculate that this deal could come off, even without an exchange rate adjustment. "On a project of that size, its not a bad deal," says one US banking executive, "the paper's trading at 55 and you wind up with 26 bolivars to the dollar, so you split the difference between the controlled rate and the free rate."

The only completely new investment approved so far is a $5 million project for a shrimp farm called Camagolto 90. The project is being shepherded by Investcorp, one of the new teams of investment bankers that have sprouted up in Caracas. Two of the three partners, Samuel Quiros and Simon Espinosa Roncajolo, described the project which they began to work with last November. The 3,000 plus acre farm is the brain-child of a group of Venezuelans who bought the site and contradicted the technical advice from a firm of ex-Halston Purina scientists, one of whom has hatcheries in Panama.

The paper for the 95% for-export project belongs to the National Bank of Washington. And therein lies one of the swaps' two obstacles. National intended to hold a bigger share than US regulations permit and so the project is said by government authorities to be back on the drawing boards.

The other stumbling block is claims by local fishing interests at La Cienagna de los Olivitos on the eastern shore of Lake Maracaibo that the farm would damage the region's ecology. Quiros and Espinosa



Chase leads the Alamsa venture.

Roncajolo admit that the permission-seeking process has been tortuous, with multiple ministries, departments and secretariats all getting in on the act. They are, none the less, optimistic and expect to be talking dollars and bolivars shortly after the end of the year.

Alamsa, a $660 million public sector joint venture with a $280 million swap component, is the winner in the size sweepstakes. Chase Manhattan will be leading the venture, without using its own paper or taking any equity. The 180,000 tonne per annum aluminium smelter investment is shared among Alcasa (30%), West Germany's Austria Motall (40%) and France's Pechiney (30%). Scheduled to be producing at 70% capacity by 1990, the project is also slated to have financing support, both direct loans and supplier credits, from Indosuez.

If the debt/equity programme takes off during 1989, the big star is likely to be not one deal, but the whole aluminium sector. Heavily promoted by a government ever more anxious to decrease its oil dependency, there are at least three big investments planned. One is the $1.3 billion Aluyana (short for Aluminios Guayana) smelter project. The participants include Italy's Italimpianti and Techint, the Venezuelan state's CVG (Corporacion Venezolana de Guayana), the Venezuelan Investment Fund, the International Aluminum Corporation and a still unidentified group of Venezuelan investors. Morgan Guaranty is negotiating another smelter investment with the CVG that is said to involve Alumax from the US and Switzerland's Alusuisse.

All told, Venezuela has plans on the drawing board that would increase aluminium production from 538,000 tpa in 1988 to over 1.8 billion tpa by 1994. And debt swapping will play an important role in most of these investments.

There's also a smattering of other big projects, like Koba's steel plant and Super Octanos' petro-chemical project. "We're at the onset of another wave of foreign investment like we had in the 1970s," predicts Perez-Segnini, "but this time there will be a much more open attitude towards foreign investment."

Bankers would like to believe that, but there is lingering doubt. Hard decisions will have to be taken and with the odds good that Carlos Andrea Perez will return to the presidency in December's elections, those with memories going back to the "spoiled-by-all" days are wondering if he will be tough enough, soon enough.

If steps are taken to realign the exchange rate and to rein in negative interest rate lending, foreign investor interest in debt/equity is bound to pick up. SIEX's head says that there are over $4 billion in planned projects, all of which are eligible for some debt/equity financing.

As it now stands, equity swapping is off limits for local investors, unless they are registered offshore. Perez-Segnini explains this, saying that Central Bank authorities do not want them to put more pressure on the bolivar free market rate or to have access to discounted investing.

Venezuela has historically had high inflation — it was just over 40% last year (the rate is based on family basket prices in Caracas) and is now registering about 20% even with controlled prices. None the less, no one seems to be anticipating emission pressures from debt/equity draws on bolivars. This could be another "good news is bad news" aspect of a major increase in investor interest. Authorities argue that the case-by-case approval process allows flexibility in doling out local currency.

But then, these potential success-related problems are the kind that officials guiding the programme would probably very much enjoy.

All these securities having been sold, this announcement appears as a matter of record only.

REPUBLIC OF VENEZUELA

US$100,000,000

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MIDLAND MONTAGU

August, 1988

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EUROMONEY

Debt management

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THE QUEEN'S AWARD FOR EXPORT ACHIEVEMENT 1983 1986

September 1988

LDC DEBT MANAGEMENT

FROM: A KILPATRICK
DATE: 30 November 1988

1. MR LANKESTER Seen in draft

2. CHANCELLOR

cc: PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Byatt
Mr Scholar
Mr Evans
Mr Mountfield
Mr Allen
Mr Culpin
Mrs Lomax
Mr Odling-Smee
Mr Peretz
Mr Walsh
Mr Bottrill
Mr Hudson
Mr Tyrie

Mr Miles BoE
Mr Jarvis UKDEL

LDC DEBT MANAGEMENT

You expressed interest (Mr Allan's minute to Mr Lankester of 30 September) in the use of new instruments for LDC debt management after reading a supplement to the September issue of Euromoney. This note, prepared with the help of the Bank of England, addresses:

i. activity in the secondary market for LDC debt;

ii. the estimated scale of debt conversion so far; and

iii. the financial institutions involved.

The annex describes the instruments currently available.

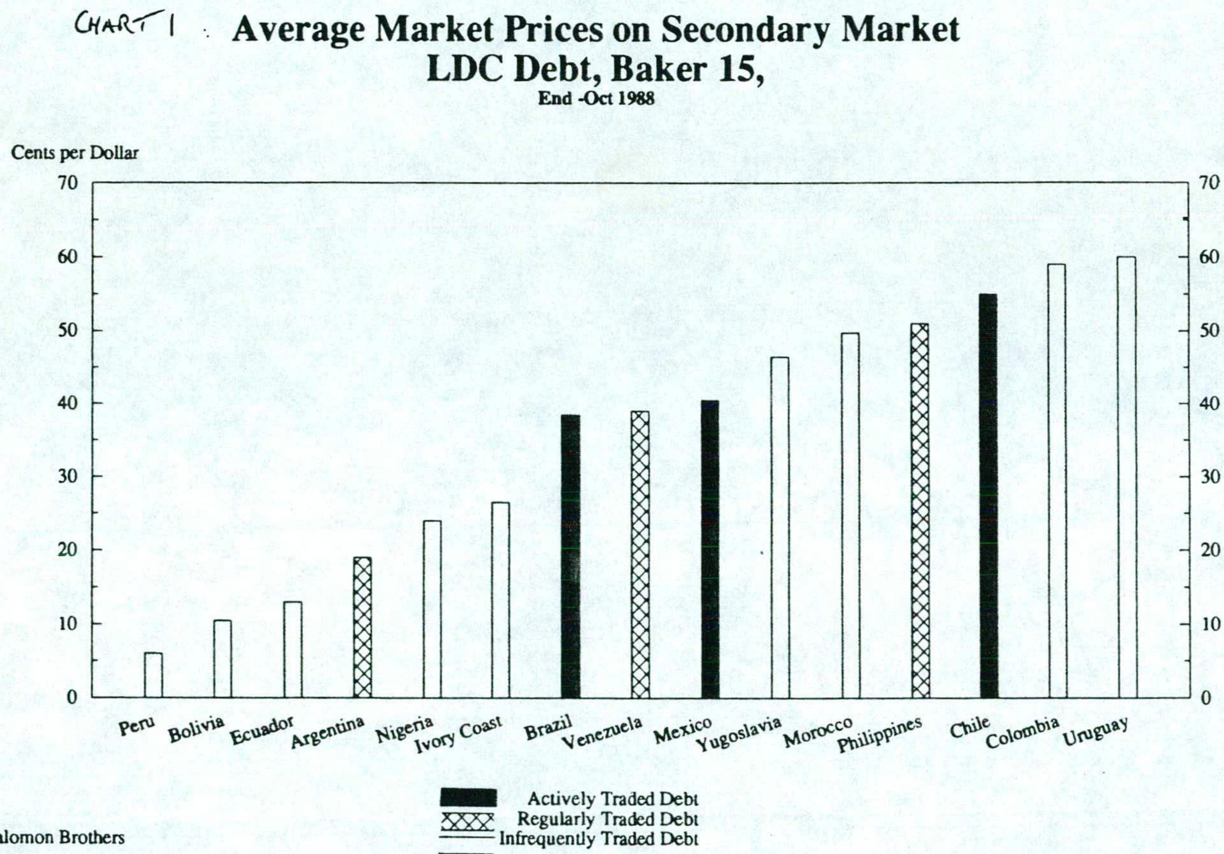
Secondary Market Activity

2. The secondary market for LDC debt is divided into 'cash' activity, where activity most frequently takes the form of debt-for-equity swaps, and a segment involving interbank swap transactions where recorded turnover is much larger. Demand by the non-bank sector for LDC debt claims has been virtually nil, except where they are to be translated into equities. Activity in debt instruments is concentrated in the paper of the two largest debtors, Brazil and Mexico, and also in Chilean debt, where a large and successful debt-for-equity programme has been in operation since May 1985.

Prices

3. A wide range of prices are quoted for LDC debt. For the Baker 15 countries shown on Chart 1, these currently range from 6 cents in the dollar (Peru) to 60 cents (Uruguay). Quoted prices, however, are generally only indicative. The thinness of the markets in many countries' debt (and the absence of market-making on any scale) means that most trades are undertaken on an individually negotiated basis. This can result in a tendency for prices to fall sharply when even comparatively small amounts of debt come onto the market. (A recent example is the sharp decline in Brazilian and Mexican debt prices following rumours that Irving Bank planned to offload $500m of debt). Market prices are also sensitive to tax, accounting and regulatory considerations.

CHART 1



Source: Salomon Brothers

Volume

4. An apparent paradox of the secondary market is that high turnover may reflect its imperfect and illiquid nature as final buyers and sellers need to use a chain of transactions in order to be matched, although more conventional market churning arising from sales between dealers may also be a factor. (The IBRD estimate that there may be 2-3 connected swaps for each one originally intended). There is no single authorative source of information on swap activity. All we have are broad estimates. The most recent IBRD estimates of market turnover for straight debt swaps this year, based on discussions with market participants, put this at $25-30bn.

5. In the 'cash' market debtors' external claims are converted into another form, reduced or extinguished. Debt conversions have mostly taken the form of debt-for-equity swaps. But other mechanisms have been used, notably this year the Mexican debt exchange scheme and Brazilian exit bonds. Significant amounts of private sector debt owed to banks have also been eliminated in these countries through prepayments at a discount. In total, external debt converted this year could amount to a face value of $16 bn. Together with the estimate for swaps this would give an overall figure for market activity in the region of $40-45bn.

Growth of the Market

6. Table 1 shows that the secondary market has grown very rapidly over the last few years, approximately doubling in size each year since 1984.

TABLE 1: ESTIMATED ACTIVITY IN SECONDARY MARKET LDC DEBT

$bn	1984	1985	1986	1987	1988f
Turnover	2	4-5	6	15-20	40-45
of which Final Demand	3/4	1 1/4	1 1/2	8	16

Source: IMF/IBRD.

Estimated Scale of Debt Conversion So Far

7. Table 2 below sets out estimates of the face value of commercial bank debt coverted in the period 1984-88. Since the preponderence of debt conversions are debt-for-equity swaps, the figures can be used as a rough guide to the amount of commercial bank debt reduction that has been achieved - although they strictly represent the upper limit. The figures in the second column show the total debt outstanding to private sector creditors (mainly banks) at the end of 1987 and the last column sets out the proportion of debt converted in relation to this total. By the end of this year the total value of debt converted since 1983 could be about $27bn, roughly 10 per cent of outstanding debt to private creditors for these countries.

Table 2: Estimates of Cumulative Debt Converted during 1984-1988: Major Countries

$bn	(1) Amount of Original Debt Converted *	(2) Debt Outstanding to Private Creditors at end-87	(1)/(2) %
Argentina	1.2	42.9	3
Bolivia	0.4	1.3	28
Brazil	7.3	88.1	8
Chile	4.4	15.2	29
Mexico	11.9	78.3	15
Philippines	1.5	15.9	10
Venezuela	0.6	32.2	2
TOTAL above	27.3	273.9	10

* Debt converted into equity, securitised debt (eg exit bonds) or cash (at a discount).

8. There is a broad correlation amongst middle income debtors between proportions of bank debt converted and the economy: debt-for-equity swaps in relatively strong countries are more attractive to investors than in weak ones.

9. The exact extent of the reduction of debt service burdens are hard to interpret. In some cases, official foreign exchange reserves have been used to transform the debt (import cover is thus traded for reduced debt service); in others new debts with different obligations have been created to replace the old. In the majority of transactions, which involve debt-for-equity swaps, debt service is replaced with (future) dividends due on the new risk capital.

Financial Institutions Involved

10. Approximately 15 principal intermediaries in New York and London are involved in the market; roughly two-thirds are commercial banks and the rest investment houses. Among the leading participants are: **Citibank, Chase Manhattan, Morgan Guaranty, Bankers Trust, Security Pacific, Bank of Montreal, Nederlandsche Middenstandsbank (NMB), Libra, Standard Chartered, Singer and Friedlander, Salomon Brothers, Shearson Lehman Hutton, Merrill Lynch,** and **Bear Stearns.** Some, such as **Security Pacific** and **Bank of Montreal** sell on their own account while others, for instance **Libra, NMB, Standard Chartered** and **Shearson Lehman,** operate mainly as intermediaries. Recently, **Morgan Grenfell** have started to take positions as well as continuing to act as a broker to debt-equity transactions; **Midland Montagu** have stated an intention to expand LDC investment banking activity; and **Ansbacher Asset Trading** have begun to trade the 'niche' area of African and East European debt.

11. Among these, **Libra** and **NMB** are large active traders based in London. In 1987, **NMB** (the source, incidentally, of a 6 page advertisment which may have caught your eye in the September supplement to Euromoney) is said to have been a party to over 900 transactions amounting in value to around 20 per cent of the market. **Libra** concluded over 800 transactions in the first half of this year (with a value of $2.2bn) and claims to be a market-

maker, although this probably does not amount to quoting firm two-way prices. The emergence of market-making is, according to the IBRD, giving some momentum to the secondary market.

<u>Conclusions</u>

12. The rapid growth in the secondary market and the amount of commercial bank debt converted so far is probably not well known. It deserves publicity. The following might be of use for eg your Bowen Wells conference speech:

i. In July 1987 (your) speech said commercial banks were paving the way for a more market-oriented approach towards meeting the financing needs of middle income debtors.

ii. Increasing amount of conversions of commercial bank debt, especially debt-for-equity swaps; cumulative conversion total since 1983 some $27bn. In some cases, notably Chile, Mexico and Bolivia, a significant proportion of debt outstanding to commercial bank creditors eliminated through market means.

iii. Used wisely, and in the right macroeconomic environment, debt-for-equity swaps are of great value. For debtors, debt burdens reduced and additional investment generated. For creditors, potential losses translated into new investments with longer-term returns.

iv. Buoyant secondary market (doubling in volume each year since 1984). Development of instruments for LDC debt conversion, such as buybacks and exit bonds - every sign that these developments will continue and facilitate LDC financing.

Andrew Kilpatrick

ANDREW KILPATRICK

ANNEX

RANGE OF INSTRUMENTS

Straight Debt Swaps: an exchange of one (or more) outstanding LDC debt(s) to commercial banks for similar debt. Motives for such interbank swaps include rationalisation and concentration of portfolios; diversification of exposure to limit country-specific price risk; varying assessments of country risk; arbitraging opportunities; differences in provisioning requirements; and tax considerations.

Debt-Equity Swaps: an arrangement whereby sovereign LDC debt denominated in foreign currency is exchanged for local currency at face value, the proceeds of which are then used to purchase an equity interest in a local company or project. In the process the value of the LDC debt exchanged is cancelled. To date this has formed the major part of the 'cash' market.

Buybacks: the purchase by a debtor country of its own sovereign debt for cash at a discount. In an agreed tender offer last year Bolivia bought back a substantial proportion of its bank debt at a discount of 89 per cent. Most recently, Chile bought back $300m of debt at an average discount of 44 per cent. To date these have been the only major occurrences of official buybacks. Demand is limited, however, not only by a shortage of funds but also by the fact that most syndicated loans have pari passu clauses which require equal treatment of that class of debt for all creditors.

Securitisation through Defeasance (the extinguishing of debt through the use of a financial asset held in a trust account as collateral against principal): an exchange of LDC debt at a discount for another (sometimes more secure) debt instrument. This includes **exit bonds** which are primarily instruments used in the context of new money packages designed to allow banks with small exposures to exit. Their advantage lies in the assumption that comfort will be obtained from the promise of no further participation in 'new money' packages (although this is not a completely watertight guarantee). The **Mexican debt-exchange** which took place earlier this year aimed to offer greater security in return for a discount on the original debt. Here principal was guaranteed by the issue of 20-year US Treasury zero-coupon bond, purchased with Mexican foreign exchange reserves, which was exchanged for the old debt at a discount. The recently announced **Japanese and French debt schemes** would appear to fall into this area.

Debt-Peso Swaps: special purpose funds created to swap foreign currency LDC debt into local currency which is then used to acquire discounted debt for eventual conversion to equity.

Debt-for-Nature Swaps: conservation organisations buy debt at a discount and finance conservation schemes in the country concerned out of the local currency profits. The main force behind this development was a change in the US tax regulations towards the end of last year which gave 100 per cent tax relief on the face value of the debt subscribed.

Debt-for-Export Schemes: the arrangement of LDC exports by banks in exchange for a reduction in its outstanding claims on the country.

chex.md/aa/25 **UNCLASSIFIED**

FROM: A C S ALLAN
DATE: 30 September 1988

MR LANKESTER 2nd.

cc PS/Economic Secretary
Sir G Littler
Mr H P Evans
Mr Mountfield
Mr Walsh
Mr Tyrie

LDC DEBT MANAGEMENT

The Chancellor was struck by the attached supplement to the latest Euromoney (attached for top copy only). The text - and especially some of the advertisements - seemed to indicate a much more active use of new instruments for debt management than the Chancellor had realised was taking place. He would be interested in your comments.

ACSA

A C S ALLAN

3/10

chex.ul/jf/2.2.12.jt UNCLASSIFIED

FROM: J M G TAYLOR

DATE: 2 DECEMBER 1988

MR KILPATRICK

cc: Sir G Littler
Mr Lankester
Mr H P Evans
Mr Walsh

LDC DEBT MANAGEMENT

The Chancellor was grateful for your note of 30 November.

J M G TAYLOR

chex.ps/ah/96

6 December 1988

INTERNATIONAL DEBT: THE WAY FORWARD

... Speaking to a Conference organised by the All Party Parliamentary Group on Overseas Development in London today, the Chancellor of the Exchequer, the Rt Hon Nigel Lawson MP, reviewed progress on the international debt problem. The text of his speech is attached. The main points are:

Approach to the debt problem

"The search for global solutions is not only mistaken, but counterproductive. It acts as a distraction from the tasks which do matter: managing the debt that remains; and helping the debtor countries to restructure their economies in a way that will improve their performance in the future."

Sub-Saharan Africa

"For the poorest countries in sub-Saharan Africa, most of the money is owed to governments and other public sector sources, and so the problem is one for governments to sort out."

"I am particularly pleased that action is now under way on all three parts of the initiative I launched in Washington last year."

- "More aid loans are now being written off."

- "Longer repayment periods with generous grace periods are now being allowed when other official loans are rescheduled."

- "Creditor countries have agreed on an approach which offered a choice of three routes to the common aim of reducing the debt burden, each involving a degree of concession."

"Both Mali and Madagascar have already benefited from these terms in rescheduling their debts. A number of other countries will be coming up over the next few months, including some from the Commonwealth."

"By breaking the vicious circle of an ever rising burden of debt, this new approach offers them some light at the end of an inevitably dark tunnel."

<u>Middle income debtors</u>

"The position of the middle income debtors is different. Most of their debts are owed to the commercial banks. And the management of these debts is emphatically a matter between the commercial banks and the countries concerned."

"There can be no question of taxpayers bailing out the banks from the consequences of their decisions."

"One of the most encouraging developments of the past year has been the increasing use of a range of market-based methods of debt reduction."

"The total amount of debt thus converted since 1983 may have reached some $25 billion"

"Debt conversion measures are much more likely to be open to countries that have a sound record of economic adjustment.

This underlines the cardinal importance of the debtor countries' pursuing the right policies. That is why it is vital that the IMF and the World Bank should continue to insist on adequate adjustment programmes."

Private sector investment

"The World Bank and its affiliates are also playing an increasing role in encouraging the growth of private direct investment."

"The UK is already showing the way. Thanks partly to the complete removal of exchange controls in 1979, our private direct investment in the developing countries has for some time now been running at a level greater than that of the rest of the European Community put together."

Nigeria

"I have one specific announcement to make."

"The Nigerian authorities have now reached agreement in principle with the Managing Director of the International Monetary Fund for a new stand-by arrangement, and they have also concluded negotiations with the World Bank for some substantial new loans. Provided the stand-by arrangement is ratified by the IMF board, and provided there are adequate contributions from other bilateral donors, the United Kingdom Government is prepared to contribute $100 million in exceptional assistance to the overall financing package, which will be largely additional to the existing UK aid programme."

Trade and the GATT round

"The industrialised countries as a whole have two responsibilities which go beyond the specific action to tackle the debt problem."

"First, there is the task of keeping the world economy itself steadily moving ahead on an even keel."

"Second, the major countries must ensure that their markets are open to those exports."

"World Bank figures suggest that protection by industrialised countries costs the developing countries more than twice the amount of official development aid they receive."

"That is why it is important that the GATT round makes progress on all fronts."

Press Office
HM Treasury
Parliament Street
LONDON SW1P 3AG

CHANCELLOR OF THE EXCHEQUER'S SPEECH TO ALL PARTY PARLIAMENTARY GROUP ON OVERSEAS DEVELOPMENT CONFERENCE, "GROWING OUT OF DEBT", 6 DECEMBER 1988

It is abundantly clear that the debt problem is going to be with us for a long time to come. Certainly, substantial progress has been made since it first erupted in 1982, and the more apocalyptic prophesies made then have been comprehensively falsified. In particular, there is no longer a serious risk of a systemic breakdown of world banking. But we are still a long way from seeing any of the debtor countries being able to return to the bond markets, and meanwhile the burden of debt weighs heavily on their peoples.

This has inevitably produced doubts about continuing with the existing case-by-case strategy. Some, on both sides, are weary of what seems to be an endless cycle of reschedulings and renegotiations. And others have always been temperamentally inclined to look for grand designs and global solutions.

But I have to say that I see no acceptable alternative to each debtor country negotiating with its creditors about the best way to manage its debts. That is what domestic borrowers do the world over. And while borrowings by sovereign states do raise some wider issues, the basic principles are just the same.

No scheme, however complicated or ingenious, can get away from the simple truth that, if debt is not repaid, someone has to bear the cost. Moreover, the debt problem did not arise from any single global development: it arose because individual countries sought to borrow from individual creditors - primarily from the commercial banks, but also to some extent from Governments and the international financial institutions - and the creditors, by and large, lent the money willingly.

Indeed, the search for global solutions is not only mistaken, but counterproductive. It acts as a distraction from the tasks which do matter: managing the debt that remains; and helping the debtor countries to restructure their economies in a way that will improve their performance in the future.

Sub-Saharan Africa

How the debt is managed is a matter for the creditor and debtor to sort out, on a case-by-case basis. For the middle-income debtors, most of the debt is owed to the commercial banks, and I shall have something to say about developments here later. But for the poorest countries in sub-Saharan Africa, most of the money is owed to governments and other public sector sources, and so the problem is one for governments to sort out. That is why I launched my debt initiative in April of last year.

The starting point for this was essentially a recognition of reality. With debt per head in these countries at about $250, and GNP per head typically less than $350, it was hardly surprising that these countries were for the most part unable to pay even the interest on their debts, let alone to repay the principal. With the interest thus being capitalised, the burden was growing exponentially. And unlike the middle-income debtors, the poorest countries simply did not have the resources or industrial base to pull their economies round.

So I warmly welcomed - and pledged full UK support for - the proposal by Michel Camdessus, the Managing Director of the IMF, to treble the size of the IMF's Structural Adjustment Facility, which provides cheap loans for poorer countries undertaking agreed economic adjustment policies. This so-called Enhanced Structural Adjustment Facility has now been set up, with the UK providing the largest single contribution to the interest subsidy. Five countries have already benefited from this new facility.

The UK has also pledged full support for the World Bank's Special Programme of Assistance for Africa, launched last December.

And I am particularly pleased that action is now under way on all three parts of the initiative I launched in Washington last year.

Agreement was reached fairly soon on my first two proposals, the writing off of old aid loans and more generous rescheduling terms. As a result more aid loans are now being written off - Germany announced a substantial package along these lines in September, and Japan has also undertaken to act along these lines on a major scale.

At the same time longer repayment periods with generous grace periods are now being allowed when other official loans are rescheduled, within the Paris Club. This process began as early as May of last year, and ten countries have so far benefited.

My third proposal was to reduce the burden of interest payments. This was a more radical step, and it understandably took longer to secure agreement. But first in principle at the Toronto Economic Summit in the Summer, and finally in detail at the international meetings in Berlin in September, creditor countries agreed on an approach which offered a choice of three routes to the common aim of reducing the debt burden, each involving a degree of concession.

- First, creditor countries can reduce the interest rates charged on loans from export credit agencies, by $3^1/_2$ percentage points, (or by halving the rate in the rare cases where it is below 7 per cent). The loan will be rescheduled over 14 years, with an 8 year grace period. This is the route the UK, along with most other creditor countries, is adopting.

- Second, creditor countries can choose to write off one-third of the debt service falling due in the period in question altogether, and to reschedule the remainder of the debt over 14 years with an 8 year grace period, but at market rates of interest.

- Third, countries who insist that they cannot accept either of the first two solutions, for legal or constitutional reasons, can reschedule their loans, again at market rates, over 25 years, with a 14 year grace period.

Both Mali and Madagascar have already benefited from these terms in rescheduling their debts. A number of other countries will be coming up over the next few months, including some from the Commonwealth.

Taken together, these developments add up to a very considerable advance in tackling the debt problems of the poorest countries in the world. By breaking the vicious circle of an ever rising burden of debt, this new approach offers them some light at the end of an inevitably dark tunnel.

The middle income debtors

Managing the debts of the countries of sub-Saharan Africa is primarily a matter for governments.

But the position of the middle income debtors is different. Most of their debts are owed to the commercial banks. And the management of these debts is emphatically a matter between the commercial banks and the countries concerned.

The commercial banks lent money to developing countries not out of a sense of altruism, but because they believed it was in their commercial interest to do so. Now that this judgement has proved sadly mistaken, there can be no question of taxpayers bailing out the banks from the consequences of their decisions. Most of the banks accept that. Those that still do not will have to do so.

It is, of course, a fact that the unwillingness of the commercial banks to lend any additional funds to the middle-income debtor countries has meant that an increasing proportion of new money and interest capitalisation has in practice been provided by the international financial institutions and by official creditors bilaterally, rather than by the banks. As a result, the proportion of total debt of the fifteen largest debtors outstanding to official institutions has risen from about one-fifth in 1982 to one-third today. But the problem of the middle-income debtors essentially remains, and must continue to remain, with the commercial banks. At the last meeting in September, the Group of Seven major industrial nations, to quote the communique, "reiterated their opposition to transferring risks from the private to the public sector".

How the banks handle the debts of the middle income countries is of course a matter for them. But one of the most encouraging developments of the past year has been the increasing use of a range of market-based methods of debt reduction. The last time that I spoke to this group in July 1987, the banks had just taken major steps to strengthen their balance sheets, raising new capital and increasing their provisions. I welcomed this move, and commented that it marked a move away from involuntary lending to lending based on commercial decisions, and paved the way to a more market-oriented approach to the provision of finance to middle income debtors.

This has proved to be the case. There has been a considerable amount of conversion of commercial bank debt through either securitisation, via debt-for-equity swaps, or straight buyback.

The total amount of debt thus converted since 1983 may have reached some $25 billion by now, with a substantial proportion of this undertaken in the past year or so. Alongside debt-equity swaps, other devices have been employed by particular countries.

- The Mexican debt-exchange scheme earlier this year has helped: Mexico's total debt converted now amounts to 15 per cent of its outstanding bank debt.

- Last year, Bolivia bought back a substantial proportion of its bank debts.

- And most recently, Chile bought back $300 million of debt, taking the total amount converted to no less than 29 per cent of its outstanding bank debt.

The majority of debt conversions take the form of debt-for-equity swaps. For the debtors, the debt burden is reduced, and additional investment generated; while creditors gain a new equity investment, with the prospect of long-term capital appreciation, in place of a holding of debt whose servicing and repayment could become increasingly uncertain. And so-called exit bonds provide a means for smaller banks to eliminate altogether their exposure to particular debtor countries, while at the same time reducing the debt burden of the countries concerned and facilitating concerted action among those banks that remain involved.

Debt conversion measures are much more likely to be open to countries that have a sound record of economic adjustment. It is no coincidence that Chile, which has such a record, has converted a higher proportion of its outstanding debt into equity than any other middle-income country. Similarly, those countries with a good economic record have proved better able to avoid capital flight, and indeed to attract fresh capital from overseas.

All this underlines the cardinal importance of the debtor countries' pursuing the right policies. This must be a prerequisite for access to further finance. Otherwise we would all be throwing good money after bad.

That is why it is vital that the IMF and the World Bank should continue to insist on adequate adjustment programmes. Inadequate programmes help nobody. They make it difficult, if not impossible, to attract support from the banks. They do not give those creditors who do come in a fair chance of a return on their money. And by delaying the return to genuine creditworthiness, and hence to the chance to benefit fully from the growth of world prosperity, they do not help the debtor country either.

Both the IMF and the World Bank have an important role to play in helping countries to grow out of their debt problems. It is essential that the two institutions work closely together, without in any way compromising the key role of the Fund.

<u>Private Direct Investment</u>

The World Bank and its affiliates are also playing an increasing role in encouraging the growth of private direct investment, which is a natural counterpart to the market-based approach to debt reduction. Private direct investment brings not just finance, but technical know-how and management experience. The track record of public sector investment in the debtor countries is not an inspiring one. It is abundantly clear that the most productive investment is likely to be that carried out in the private sector. So it is encouraging that that is where a growing number of new projects are taking place.

There is more mobile capital in the world today than ever before. So the scope for attracting private funds for investment is considerable. By the same token, there are investment opportunities all over the world, and investors will only put their money in countries where there is the prospect of a reasonable return.

I therefore support wholeheartedly the recommendation of the World Bank's Private Sector Development Review Group that the Bank should pay more attention, in its policy-based lending, to overcoming factors which deter private direct investment. And a new World Bank institution, the Multilateral Investment Guarantee Agency, of which the UK is a founder-member, is now in place, providing advice on how countries can attract inward investment, coupled with guarantees to investors against non-commercial risks.

The signs are encouraging. Private direct investment in the major 15 debtor countries has risen from £4.7 billion in 1987 to some £8 billion this year. Most of this is accounted for by new investment in Mexico and Brazil. But direct investment is rising elsewhere too.

I am quite sure that increased private direct investment has an important role to play in future. The UK is already showing the way. Thanks partly to the complete removal of exchange controls in 1979, our private direct investment in the developing countries has for some time now been running at a level greater than that of the rest of the European Community put together.

<u>Nigeria</u>

The problems and possibilities of adjustment and of raising new finance differ from country to country - which of course is the rationale of the so-called case-by-case approach. In this context, I have one specific announcement to make.

The Nigerian economy has been very badly hit in recent years by the fall in oil prices and, with some $30 billion of external debt to service, the Nigerians have faced a formidable task of adjustment. Without renewed efforts by the Nigerian authorities and in the absence of increased assistance from the international financial community, Nigeria's economic prospects were beginning to look very grim indeed.

The Nigerian authorities have now reached agreement in principle with the Managing Director of the International Monetary Fund for a new stand-by arrangement, and they have also concluded negotiations with the World Bank for some substantial new loans. Provided the stand-by arrangement is ratified by the IMF board, and provided there are adequate contributions from other bilateral donors, the United Kingdom Government is prepared to contribute $100 million in exceptional assistance to the overall financing package, which will be largely additional to the existing UK aid programme.

It will of course be imperative that Nigeria, like other countries trying to conquer their debt problems, should persevere with domestic policy reform. Without that, no amount of overseas assistance will be effective.

<u>Trade</u>

You have entitled this conference "Growing Out of Debt". And while that must not be interpreted to mean a dash for growth at any price, it is clear that sustainable economic development is a prerequisite for the debtor countries once again to play a normal part in the world economy. To enable them to do this, the industrialised countries as a whole have two responsibilities which go beyond the specific action to tackle the debt problem which I have discussed.

First, there is the task of keeping the world economy itself steadily moving ahead on an even keel. The major industrial countries have now seen six years uninterrupted growth at an average rate of $3^1/_2$ per cent a year, the best performance for over 20 years. It is vital that we stick to the policies which have produced this expansion,and in particular that we keep inflation under control. Steady and sustainable expansion in the industrial countries means a higher demand for the exports of the debtor countries.

Second, the major countries must ensure that their markets are open to those exports. This is, of course, a particularly topical issue, with the Mid-Term Meeting of the GATT round at this very moment under way in Montreal.

Although many developing countries still protect their trade heavily, a recent IMF study showed that, among the developing countries, liberalising changes outnumbered restrictive changes by nearly 2 to 1 last year. Unfortunately, in the industrialised world, protectionist moves, of one kind or another, including voluntary restraint arrangements and unjustified anti-dumping duties, were in the majority.

World Bank figures suggest that protection by industrialised countries costs the developing countries more than twice the amount of official development aid they receive. We all know how the difficulties faced by the developing countries lead to calls for ever-increasing intervention, including extra aid, from the Governments of the major countries. It is ironic, to say the least, that very often the best thing those Governments could do would be to get out of the way, by eliminating protection, and allowing the developing countries the access to markets which they need to increase their exports.

That is why it is important that the GATT round makes progress on all fronts. I hope that the current Montreal meeting can achieve specific agreements, in a number of areas - and one of particular importance to developing countries is tropical products. In other areas, the job is to agree on a framework for future negotiations. Above all, we must keep the multilateral GATT framework going. That is of vital importance to industrialised and developing countries alike.

Conclusion

To conclude, there can be no doubt that the world economy is in better shape, and an important range of new measures is now in place. Even so, the resolution of the debt problem will be neither quick, nor easy. But provided all sides play their parts - and I can assure you that this country will continue to do so - cautious optimism is fully justified.

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FM DAKAR
TO ROUTINE FCO
TELNO 363
OF 091045Z DECEMBER 88
ROUTINE HM TREASURY
INFO ROUTINE UKDEL IMF/IBRD

YOUR TELNO 332 TO ABIDJAN: SUB-SAHARAN AFRICAN DEBT

1 I NOTE THAT SENEGAL'S ELIGIBILITY FOR POST TORONTO RELIEF IN THE PARIS CLUUB HANGS IN THE BALANCE (PARA 5 OF TUR).

2 ALTHOUGH THE CASE OF SENEGAL IS NOT PARTICULARLY IMPORTANT IN TERMS OF OUR OVERALL INTERESTS I HOPE THAT WHEN THE PARIS CLUB DISCUSSION IS RESUMED (MOUNTFIELD'S NOTE FOR RECORD OF 17 NOVEMBER) WE SHALL BE ABLE TO TAKE A SYMPATHETIC ATTITUDE. EVEN IF THE DELIBERATIONS OF THE PARIS CLUB ARE CONFIDENTIAL THE ATTITUDE OF INDIVIDUAL DONORS IS BOUND TO LEAK OUT. WHATEVER THE FINAL CONCLUSION WE SHOULD CERTAINLY LOSE SOME OF THE GOODWILL ENGENDERED BY THE STATE VISIT (DURING WHICH THE HELPFUL ROLE OF THE CHANCELLER WAS FULLY RECOGNISED) IF IT WERE DISCOVERED THAT WE HAD LINED UP AGAINST SENEGAL'S INCLUSION. IT WOULD BE A POSITIVE STEP IF WE COULD EXPRESS OURSELVES IN SUPPORT OF TORONTO TERMS FOR SENEGAL - AS THE US DID AT THE 15 NOVEMBER MEETING - ON THE BASIS OF SENEGAL' S RELATIVELY GOOD ADJUSTMENT RECORD SO FAR.

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CONFIDENTIAL
FM FCO
TO ROUTINE DAKAR
TELNO 233
OF 091745Z DECEMBER 88

YOUR TELNO 363: SUB-SAHARAN AFRICAN DEBT

1. THE UK WILL NOT (NOT) RESIST TORONTO TERMS FOR SENEGAL, BUT IT IS NOT YET CERTAIN WHETHER THERE WILL BE A CONSENSUS IN FAVOUR. IT ALL DEPENDS ON THE FRENCH WHO ARE THE MAJOR CREDITOR. AS A MINIMAL CREDITOR IT WOULD NOT BE APPROPRIATE FOR THE UK TO PLAY A LARGE PART IN THE DEBATE.

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CONFIDENTIAL
FM WARSAW
TO IMMEDIATE FCO
TELNO 747
OF 130830Z DECEMBER 88
INFO PRIORITY UKDEL IMF/IBRD WASHINGTON, WASHINGTON, BONN, PARIS

UKDEL IMF/IBRD TELNO 268 : POLISH DEBT

SUMMARY

1. A CASE FOR INITIATING IMF NEGOTIATIONS WITH POLAND DESPITE DIFFICULTIES OVER THE PARIS CLUB AGREEMENT.

DETAIL

2. SUBJECT TO WHAT MAY TRANSPIRE DURING SAWICKI'S CALL ON MOUNTFIELD ON 14 DECEMBER, IT NOW SEEMS THAT THE POLES HAVE NO INTENTION, AT LEAST IN THE SHORT TERM, OF CONCLUDING THE VARIOUS BILATERAL AGREEMENTS UNDER THE DECEMBER 1987 PARIS CLUB AGREEMENT (MY TELNO 06 TO ECGD). THIS IS OF COURSE DISAPPOINTING IN SO FAR AS IT REFLECTS A POLISH ASSESSMENT OF THEIR INABILITY TO MEET THEIR OBLIGATIONS, AND EXASPERATING IN SO FAR AS IT REFLECTS SOME DOWNGRADING OF DEBT REPAYMENT IN POLAND'S ORDER OF ECONOMIC PRIORITIES. NEVERTHELESS (AND AGAIN SUBJECT TO THE TERMS OF WROBLEWSKI'S LETTER) I AGREE WITH PRUST THAT IT IS IMPORTANT NOT TO BE TOO DISCOURAGING IN RESPONDING TO POLAND'S RENEWED APPROACH TO THE IMF. MY REASONS FLOW FROM THE WESTERN INTEREST:

(A) TO OBTAIN REPAYMENT OF POLISH DEBTS:

(B) TO ENCOURAGE THE POLES TO PRESS ON WITH MEASURES TO REFORM THEIR ECONOMIC SYSTEM, WHICH IN TIME WILL LEAD THEM TO INCREASE IMPORTS FROM THE WEST:

(C) TO SUPPORT IN THIS WAY FORCES WORKING FOR CHANGE IN POLAND ON THE ASSUMPTION THAT SOONER OR LATER ECONOMIC CHANGE WILL HAVE TO BE PARALLELED BY CHANGE IN THE POLITICAL AND SOCIAL SPHERE.

3. FOR THE FIRST TIME IN SEVERAL MONTHS, THERE IS A SENSE THAT THE POLISH GOVERNMENT IS EMERGING FROM A PERIOD OF MUDDLE AND UNCERTAINTY OVER ECONOMIC POLICY AND PURSUING A VIGOROUS PROGRAMME

OF REFORM. MAJOR ECONOMIC PACKAGES, AFFECTING THE INTERNAL ECONOMY, FOREIGN INVESTMENT AND TRADE, AND FOREIGN CURRENCY HAVE BEEN SIGNIFICANTLY AMENDED AND STRENGTHENED BY THE RAKOWSKI GOVERNMENT, AND WILL BE ON THE STATUTE BOOKS IN A MATTER OF WEEKS. RAKOWSKI, AND TO SOME EXTENT JARUZELSKI HIMSELF, HAVE STAKED THEIR REPUTATIONS ON THE SUCCESS OF THESE REFORMS. IT WOULD BE FOOLISH AT THIS STAGE TO PREDICT THAT THEY WILL LEAD TO A SUSTAINED IMPROVEMENT IN THE PROFITABILITY AND EXPORT PERFORMANCE OF THE POLISH ECONOMY. THERE ARE STILL TOO MANY UNKNOWNS, NOT LEAST THE INTERFERACE BETWEEN ECONOMIC AND POLITICAL REFORM. BUT THE PACKAGES INCLUDE A NUMBER OF WELCOME PROVISIONS FROM OUR POINT OF VIEW : EQUAL STATUS FOR PRIVATE SECTOR AND STATE-OWNED ENTERPRISES (INCLUDING EQUAL TAXATION, NO LIMITS ON EMPLOYMENT FOR PRIVATE FIRMS, AND LESS DISCRIMINATORY ACCESS TO GOODS) : PERMISSION FOR WHOLLY FOREIGN- OWNED FIRMS TO SET UP IN POLAND (WITH FOREIGN NATIONALS IN CHARGE, GREATER HARD CURRENCY RETENTION RIGHTS, LOWER TAXATION LEVELS AND TAX FREE PERIODS) : AND LIBERALISATION OF HARD CURRENCY LAWS. POLISH/IMF DISCUSSIONS COULD PROVIDE WESTERN CREDITORS WITH A VALUABLE OPPORTUNITY TO STRENGTHEN THE RESOLVE OF THE GOVERNMENT AND, AS NECESSARY, TO EXPLOIT TO OUR ADVANTAGE ANY REMAINING FLEXIBILITY IN THEIR APPROACH.

4. MORE PARTICULARLY, SUCH DISCUSSIONS COULD OFFER A VEHICLE FOR PRESSING THE POLES ON DEBT REPAYMENT, AND ENSURING THAT THIS IS GIVEN ADEQUATE PRIORITY IN THEIR ECONOMIC PLANS. DISCUSSIONS WITH THE IMF WOULD BE ALL THE MORE VALUABLE IF THOSE IN THE PARIS CLUB CONTEXT ARE ON THE BACK BURNER. IN ANY CASE, AS DEMANDEURS FOR AN IMF AGREEMENT, THE POLES WOULD ARGUABLY BE MORE SUSCEPTIBLE TO PRESSURE IN THAT FORUM THAN ELSEWHERE.

5. IN SHORT, IT IS NOT LIKELY TO SERVE EITHER OUR INTERESTS AS CREDITORS, OR THE PROSPECTS FOR A SUCCESSFUL REFORM OF THE POLISH ECONOMY, TO LET EXASPERATION OVER POLISH BEHAVIOUR IN THE PARIS CLUB DETERMINE OUR RESPONSE TO THEIR APPROACH TO THE IMF. ANY LINKAGE, I SUGGEST, SHOULD BE BETWEEN CONCLUSION OF AN IMF AGREEMENT (AS DISTINCT FROM INITIATION OF NEGOTIATIONS) AND THE SITUATION OF THE PARIS CLUB FRONT.

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OF 301200Z DECEMBER 88
AND TO IMMEDIATE MADRID, THE HAGUE
INFO PRIORITY DAKAR, OTTAWA, PARIS, LA PAZ

SENEGAL: DEBT CONCESSIONS AT THE PARIS CLUB

SUMMARY
1. CANADIANS AND FRENCH PROPOSE UK JOIN THEM IN DEMARCHES TO GOVERNMENTS OF BELGIUM, SPAIN AND THE NETHERLANDS TO URGE THEM TO LIFT THEIR BLOCKING OF THE CONCESSIONAL RESCHEDULING OF SENEGAL'S OFFICIAL DEBTS IN THE PARIS CLUB. IF APPROACHED BY FRENCH COUNTERPARTS YOU SHOULD AGREE TO PARTICIPATE IN A JOINT DEMARCHE IN COMPANY WITH THEM AND CANADIANS. HOST GOVERNMENTS MUST BE APPROACHED EARLY IN THE FIRST WEEK IN JANUARY.

DETAIL
2. FCO TELNO 225 OF 6 JULY REPORTED THE AGREEMENT REACHED AT THE TORONTO ECONOMIC SUMMIT ON EXCEPTIONAL MEASURES TO ALLEVIATE THE BURDEN OF THE DEBT OWED TO DEVELOPED COUNTRY GOVERNMENTS BY THE POOREST MOST INDEBTED COUNTRIES IN SUB-SAHARAN AFRICA PURSUING INTERNATIONALLY AGREED ECONOMIC REFORM PROGRAMMES. THIS FOLLOWED THE INITIATIVE LAUNCHED BY THE CHANCELLOR OF THE EXCHEQUER IN APRIL 1987. FIVE COUNTRIES HAVE NOW RECEIVED CONCESSIONAL RESCHEDULINGS - MALI, MADAGASCAR, TANZANIA, NIGER, CENTRAL AFRICAN REPUBLIC. FCO TELNOS 331 AND 332 OF 5 DECEMBER (NOW REPEATED TO BRUSSELS AND MADRID) GIVE FURTHER DETAILS OF THE SCHEME.
3. ECGD TELNO 9 OF 20 DECEMBER (NOW REPEATED TO YOU) REPORTED THE FAILURE OF CREDITORS TO AGREE AT THE 15 DECEMBER MEETING OF THE PARIS CLUB ON WHETHER SENEGAL SHOULD BENEFIT FROM THE TORONTO CONCESSIONS. DISCUSSION CENTRED ON WHETHER THE RISE IN SENEGAL'S PER CAPITA INCOME TO USDLR510 IN THE LATEST WORLD BANK FIGURES MAKES IT INELIGIBLE (SEE PARA 5 OF TELNO 332). CREDITORS HAVE NOT AGREED ON A FIRM PER CAPITA INCOME CUT OFF FOR ELIGIBILITY: THE PARIS CLUB DOCUMENT REFERS TO QUOTE A CRITERION OF POVERTY, NOTABLY EFFECTIVE ELIGIBILITY FOR IDA LOANS UNQUOTE. THE WORLD BANK HAVE CONFIRMED THAT THEY WILL CONTINUE TO REGARD SENEGAL AS A QUOTE IDA-ONLY COUNTRY. BUT SOME CREDITORS INTERPRET THE CRITERION AS REFERRING TO THE WORLD BANK'S PUBLISHED QUOTE SPECIAL WORKS PREFERENCE THREASHOLD UNQUOTE OF US DOLLARS 480.

4. BELGIUM, SPAIN AND THE NETHERLANDS OPPOSED THE CONCESSIONS. BELGIUM AND THE NETHERLANDS HAVE CONSISTENTLY ARGUED FOR THE NARROWEST POSSIBLE ELIGIBILITY DEFINITION. SPAIN'S OPPOSITION WAS APPARENTLY PARTLY IN PROTEST AGAINST CREDITORS' RECENT DECISION NOT (NOT) TO EXTEND THE CONCESSIONS TO BOLIVIA. ALL OTHER CREDITORS SUPPORTED THE APPLICATION OF TORONTO TERMS TO SENEGAL.SENEGAL'S GOOD ADJUSTMENT RECORD CLEARLY COUNTED IN ITS FAVOUR. THE UK IS A SMALL CREDITOR IN SENEGAL, AND WAS CONTENT TO FOLLOW THE MAJORITY.WE ARGUED THAT POLICY ON GRADUATION OUT OF ELIGIBILITY FOR THE TORONTO CONCESSIONS FOR COUNTRIES WHOSE PER CAPITA INCOME IS RISING HAS YET TO BE PROPERLY ADDRESSED BY THE PARIS CLUB: THERE ARE DIFFICULTIES ABOUT PENALISING GOOD ADJUSTERS IN THIS WAY.

5. IT WAS AGREED THAT ALL CREDITORS WOULD REVIEW THEIR POSITION AND REVERT TO THE PARIS CLUB CHAIRMAN BY 6 JANUARY. IF CREDITORS ARE THEN IN AGREEMENT ON SENEGAL'S ELIGIBILITY FOR THE CONCESSIONS THE PARIS CLUB WILL PROCEED TO RESCHEDULING SENEGAL'S DEBTS AT ITS MEETING IN THE WEEK OF 23 JANUARY.

6. FRANCE, THE LARGEST CREDITOR, IS ANXIOUS TO SEE SENEGAL BENEFIT. THEY AND THE CANADIANS HAVE SUGGESTED JOINT FRANCE/CANADA/UK DEMARCHES TO THE GOVERNMENTS OF BELGIUM, SPAIN AND THE NETHERLANDS. SINCE THE AIM IS TO INFLUENCE DECISIONS BEFORE THE 6 JANUARY DEADLINE, TIME IS PROBABLY TOO SHORT TO NEGOTIATE A WRITTEN MESSAGE. THE FRENCH ARE LIKELY TO SUGGEST YOU PARTICIPATE IN A PERSONAL DEMARCHE AT AMBASSADORIAL LEVEL EARLY NEXT WEEK.

7. ALTHOUGH WE ARE A MINOR CREDITOR, AND WE WOULD NOT WANT TO MAKE BILATERAL APPROACHES ON THIS ISSUE, THERE ARE STRONG REASONS FOR PARTICIPATING IN JOINT DEMARCHES IN THE THREE CAPITALS WITH FRANCE IN THE LEAD:

(1) SINCE THE TORONTO CONCESSIONS ARE BASED ON THE CHANCELLOR'S INITIATIVE, WE HAVE A SPECIAL INTEREST IN THEIR IMPLEMENTATION:

(2) WE WANT TO BE SEEN TO BE SUPPORTING SENEGAL IN THE WAKE OF PRESIDENT DIOUF'S SUCCESSFUL STATE VISIT IN NOVEMBER:

(3) FRANCE HAS MADE IT CLEAR THAT IN RETURN FOR ANY SUPPORT THEY PROVIDE FOR THE INTERNATIONAL AID PACKAGE FOR NIGERIA THEY WILL BE SEEKING SOME UK SUPPORT IN FRANCOPHONE AFRICA. OUR FREEDOM FOR MANOEUVRE ON BILATERAL AID IS VERY LIMITED: WE MUST THEREFORE MAKE THE MOST OF OPPORTUNITIES IN MULTILATERAL FORA.

LINE TO TAKE

8. YOU SHOULD AGREE TO ANY FRENCH REQUEST TO PARTICIPATE TOGETHER WITH THEM AND THE CANADIANS IN MEETINGS WITH SUITABLE INTERLOCUTORS FROM YOUR HOST COUNTRIES. IN SUCH MEETINGS YOU SHOULD DRAW ON THE FOLLOWING POINTS IN SUPPORT OF YOUR

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COLLEAGUES
- MAJORITY OF CREDITORS IN FAVOUR. PARIS CLUB CAN ONLY OPERATE BY CONSENSUS, WHICH REQUIRES SOME FLEXIBILITY PARTICULARLY FROM CREDITORS WITHOUT LARGE EXPOSURES:
- NOT (NOT) CLEAR THAT SENEGAL INELIGIBLE ON INCOME GROUNDS. CREDITORS HAVE NOT AGREED FIXED INCOME CUT-OFF FIGURE. PARIS CLUB DOCUMENT REFERS ONLY TO IDA-ELIGIBILITY, AND WORLD BANK HAVE CONFIRMED SENEGAL WILL CONTINUE TO BE IDA-ONLY ELIGIBLE. DECISIONS ON ELIGIBILITY MUST BE TAKEN ON CASE BY CASE BASIS. SENEGAL REMAINS ONE OF THE POOREST MOST HEAVILY INDEBTED COUNTRIES FOR WHOM TORONTO CONCESSIONS WERE DESIGNED.
- WILL NEED TO CONSIDER GRADUATION FROM TORONTO CONCESSIONS FOR COUNTRIES WHOSE PER CAPITA INCOMES ARE RISING. BUT RAISES IMPORTANT POLICY QUESTIONS WHICH CREDITORS HAVE NOT YET DISCUSSED. TOO EARLY IN THE OPERATION OF THE SCHEME TO TACKLE THIS QUESTION. UK SUPPORT NOW FOR SENEGAL DOES NOT SET A PRECEDENT FOR OUR POSITION EITHER ON ANY FUTURE RESCHEDULING FOR SENEGAL OR ON RESCHEDULINGS FOR OTHER COUNTRIES WHICH MAY BE CANDIDATES FOR GRADUATION.
- SENEGAL'S GOOD ADJUSTMENT RECORD IS A POINT IN ITS FAVOUR.
- (FOR MADRID) SENEGAL'S CASE IS NOT PARALLEL TO THAT OF BOLIVIA. SENEGAL IS POORER THAN BOLIVIA (ON WORLD BANK FIGURES SENEGAL'S PER CAPITA INCOME IS US DOLLARS 510 AND BOLIVIA'S IS 570. BOLIVIA'S IS MORE LIKELY TO BE UNDERSTATED BECAUSE OF THE LARGE UNOFFICIAL SECTOR). MUCH MORE OF SENEGAL'S DEBT IS OWED TO PARIS CLUB CREDITORS. (DEFENSIVE - ACCEPT THAT THERE IS NO GEOGRAPHICAL CRITERION LIMITING CONCESSIONS TO AFRICA. COUNTRIES ARE CONSIDERED ON A CASE BY CASE BASIS. THEREFORE IMPORTANT THAT ALL CREDITORS LOOK AT EACH CASE ON ITS OWN MERITS. IF OTHER CREDITORS BELIEVED THAT SENEGAL (LIKE BOLIVIA) COULD BRIDGE ITS FINANCING GAP BY RESCHEDULING ON CONVENTIONAL TERMS THEY WOULD NOT BE PRESSING FOR TORONTO CONCESSIONS.)

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FROM MURRAY

VENEZUELA: DEBT

SUMMARY

1. VENEZUELA ANNOUNCES SUSPENSION FROM MID-JANUARY OF CAPITAL REPAYMENTS ON MUCH OF HER INTERNATIONAL DEBT.

DETAIL

2. IN HIS END-OF-YEAR ADDRESS ON 31 DECEMBER, PRESIDENT LUSINCHI ANNOUNCED THE SUSPENSION OF CAPITAL REPAYMENTS ON PART OF VENEZUELA'S FOREIGN DEBT, WITH EFFECT FROM 17 JANUARY. THE MEASURE COVERS BOTH RESTRUCTURED AND PRE-1983 UNRESTRUCTURED PUBLIC SECTOR BANK DEBT (A TOTAL OF APPROXIMATELY US DOLLARS 24 BN). CAPITAL PAYMENTS OF THIS DEBT DUE IN 1989 TOTAL US DOLLARS 1,532 M.

3. THE ANNOUNCEMENT FOLLOWS THE FAILURE OF THE THREE-MAN TEAM OF RODRIGUEZ, TINOCO AND LAURIA (BARTON'S LETTER OF 23 DECEMBER TO HOOK, ECONOMIC ADVISERS) TO SECURE FRESH FUNDS DURING THEIR RECENT TALKS WITH US CREDITOR BANKS, THE US GOVERNMENT AND THE IFIS. THE FINANCE MINISTER, HURTADO, WROTE TO CHASE MANHATTAN (WHO HOLD THE CHAIR OF VENEZUELA'S BANKS' ADVISORY COMMITTEE) ON 30 DECEMBER TO INFORM THEM OF THE SUSPENSION. THE NEXT STEP WILL BE FOR A VENEZUELAN DELEGATION TO TRAVEL SOON TO NEW YORK TO OPEN NEGOTIATIONS WITH THE COMMITTEE. THE VENEZUELANS WILL ASK FOR A GRACE PERIOD BEFORE CAPITAL PAYMENTS RECOMMENCE AND, PROBABLY, FOR A REDUCTION IN INTEREST RATES.

4. REACTION HERE TO THE ANNOUNCEMENT HAS BEEN GENERALLY FAVOURABLE, ALTHOUGH SOME ARE SAYING THAT IT IS TOO LITTLE TOO LATE. PRESIDENT-ELECT CARLOS ANDRES PEREZ (CAP) HAS SAID THAT HE SUPPORTS THE MOVE, WHICH HE KNEW OF IN ADVANCE.

4REINALB FIGUEREB , ONE OF CAP'S CLOSEST ADVISERS, HAS SAID THAT THAT THE SUSPENSION DOES NOT REPRESENT A MORATORIUM ON REPAYMENTS. SIMILARLY THE CENTRAL BANK PRESIDENT, GARCIA ARAUJO, HAS SAID THAT LETTERS OF CREDIT ETC. WILL NOT BE AFFECTED.

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REC.	09 JAN1989
ACTION	Mr WALSH
COPIES TO	Mr WICKS
	Mr LANKESTER
	Mr H.P. EVANS
	Mr MOUNTFIELD

THE INSTITUTE OF INTERNATIONAL FINANCE, INC.
2000 PENNSYLVANIA AVENUE, N.W. SUITE 8500
WASHINGTON, D.C. 20006

*Report with top copy only

Horst Schulmann
Managing Director

January 6, 1989

His Excellency
Nigel Lawson
Chancellor of the Exchequer
H.M. Treasury
Parliament Street
London SW1P 3AG United Kingdom

Dear Chancellor,

On January 11, 1989, the Institute will release a major new report entitled "The Way Forward for Middle-Income Countries" which provides the point of view of the commercial banks on the economic and financial problems of the heavily indebted countries. This is a consensus document drawn from the work of an Institute task force of leading American, Canadian, European and Japanese banks and approved by the IIF Board at its December 1988 meeting. It is meant to serve as a basis for dialogue between commercial banks and governments as the reassessment of the current debt management strategy gets underway.

On behalf of the Board of Directors of the Institute, I am enclosing a copy of that report. As stated in the report, the Institute and its members are prepared to collaborate constructively with creditor governments and the international financial institutions to assist the debtor countries in regaining market access.

Sincerely,

Horst Schulmann

TELEPHONE (202) 857-3604 TELEX 64165-IIF FAX (202) 775-1430

FROM: H G WALSH
DATE: 10 January 1989

PS/CHANCELLOR

cc: Mr Wicks
Mr Lankester
Mr Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Kilpatrick
Mr Tarkowski
Mr Segal*
Mr Tyrie

* with report

Ch/
Content for me to write on the lines suggested?
[initials] 10/1

OK –

INSTITUTE OF INTERNATIONAL FINANCE: REPORT ON MIDDLE INCOME DEBTORS

The Report attached to Horst Schulmann's letter of 6 January to the Chancellor will be published tomorrow, and may attract some attention in the press. It presents a consensus of the views of American, Canadian, European and Japanese banks on the middle income debt situation.

2. As might be expected, the document presents the facts very much from the point of view of the commercial banks. It presents a very strong case against mandatory debt forgiveness and advocates voluntary debt reduction on the basis that this will happen when it is in the banks' own commercial interests.

3. The Report shows some sensitivity to the criticism that the commercial banks are now not providing sufficient quantities of new money to middle income debtors. It points to the failure of many of the countries to perform, the need to provision against new lending and an erosion in the base for lending as some of the reasons for this. The Institute calls for better economic performance from the debtor countries and a wider range of options as were incorporated in the recent Brazilian package.

4. Despite the fact that the IIF's own figures show that the total exposure of the public sector has increased from 22 per cent of the total external debt of the Baker 15 in 1982 to 37 per cent

now (with a decline of 77 per cent to 63 per cent of the private sector) the Institute is not inhibited from calling for a greater public sector effort in terms of more World Bank and IMF lending and use of World Bank guarantees.

5. If a line is required for use with the press, it might be along the following lines:-

> "The Institute's Report confirms that there is no alternative but to continue with the existing case-by-case approach to the debt strategy, combining finance with growth-orientated adjustment in the middle income debtor countries. The figures in the Report also justify the concern that an increasing proportion of exposure to middle income debtors is borne by the public sector including bilateral official creditors and the international financial institutions. This has risen, according to the Report, from 22 per cent in 1982 to 37 per cent in 1988."

6. You may also wish to send a short acknowledgement to Horst Schulmann along the lines of the attached draft.

H.W.

H G WALSH

Psc type final.

DRAFT PRIVATE SECRETARY LETTER

TO: Horst Schulmann
Managing Director
The Institute of International Finance
2000 Pennsylvania Avenue
Washington

Thank you for your letter to the Chancellor of 6 January, and for attaching a copy of the IIF's latest report "The Way Forward for Middle-Income Debtors". This will be read with interest here.

JMG T—
P— S—

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Treasury Chambers, Parliament Street, SW1P
01-270 3000

PWP

cc Mr Wicks
Mr Lankester
Mr Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Kilpatrick
Mr Tarkowski
Mr Segal*
Mr Walsh
Mr Tyrie
* with report

12 January 1989

Horst Schulmann
Managing Director
The Institute of International Finance
2000 Pennsylvania Avenue
Washington

Dear Mr Schulmann

Thank you for your letter to the Chancellor of 6 January, and for attaching a copy of the IIF's latest report "The Way Forward for Middle-Income Debtors". This will be read with interest here.

Yours sincerely

Jonathan Taylor

J M G TAYLOR
Private Secretary

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YOUR EXCED 001: DEBT RECONCILIATION

SUMMARY

1. NEED FOR RAPID CONCLUSION OF DEBT RECONCILIATION PROCESS RAISED WITH GOVERNOR OF CENTRAL BANK AND DIRECTOR-GENERAL FINANCE. BOTH PROMISE EARLY NEWS ON POSITION REACHED. FURTHER ECGD DEBT TEAM VISIT MAY BE NEEDED TO EXPEDITE MATTERS BEFORE PARIS CLUB MEETING. DATES REQUESTED.

DETAIL

2. IN HIGH COMMISSIONER'S ABSENCE ON TOUR IN NORTHERN NIGERIA, COUNSELLOR (ECONOMIC AND COMMERCIAL) CALLED ON GOVERNOR AHMED OF CENTRAL BANK (CBN) ON 17 JANUARY AND U K BELLO, DIRECTOR-GENERAL FEDERAL MINISTRY OF FINANCE (FMG) ON 18 JANUARY. BROAD MADE THE POINTS IN YOUR TUR AND LEFT AN AIDE MEMOIRE (COPY TO YOUD, ECGD, BY BAG).

3. AHMED, WHO WAS FLANKED BY DEPUTY GOVERNOR USMAN, VOLUNTEERED IMMEDIATE APPRECIATION OF BRITISH CONTRIBUTION AT 9 JANUARY LONDON MEETING AND SAID IT WAS IMPORTANT IN VIEW OF KEY ROLE BRITISH DELEGATION WOULD PLAY AT PARIS CLUB MEETING THAT BRITISH REPRESENTATIVES SHOULD ARRIVE THERE FEELING COMFORTABLE OVER DEBT RECONCILIATION. PREOCCUPATION WITH OTHER MATTERS HAD DIVERTED CBN'S ATTENTION FROM MOVING EXERCISE FORWARD SINCE YOUD'S VISIT IN OCTOBER. WHEN ASKED WHETHER FURTHER VISIT BY ECGD WOULD BE HELPFUL AT THIS POINT, AHMED SAID HE WOULD PREFER CBN TO DO THEIR HOMEWORK FIRST AND THEN ARRANGE FOR A VISIT IF IT WOULD INDEED HELP. HE ASKED USMAN TO LET US KNOW POSITION IN A COUPLE OF DAYS.

4. U K BELLO RESPONDED SIMILARLY. HE SAID HE HAD THOUGHT MEDIUM TERM RECONCILIATION HAD BEEN COMPLETED. HE WROTE INSTRUCTION TO OBARO, DIRECTOR OF EXTERNAL FINANCE, TO LET US KNOW POSITION SOONEST. IN RESPONSEE TO OUR QUESTION, HE FELT ECGD VISIT COULD WELL BE NEEDED BEFORE PARIS CLUB MEETING.

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COMMENT

5. WE WILL SEEK TO ESTABLISH PRECISELY WHERE THINGS STAND WITH CBN AND FMF ON 23 JANUARY (IF THEY DO NOT CONTACT US BEFORE THEN), AND IN PARTICULAR WHETHER FURTHER VISIT BY YOUD WOULD HELP TO ACHIEVE PROGRESS. PAST EXPERIENCE SUGGESTS THAT ECGD'S DETAILED KNOWLEDGE OF INDIVIDUAL DEBTS, OVERALL METHODOLOGY AND BASIS FOR CALCULATION OF INTEREST PAYMENTS IS NEEDED TO CONCENTRATE NIGERIAN MINDS AND ACCELERATE PEACE OF RECONCILIATION. GRATEFUL THEREFORE TO KNOW IF YOUD IS ABLE TO VISIT IN WEEKS OF 30 JANUARY AND 6 FEBRUARY, AND IF SO FOR PROPOSALS ON SPECIFIC DATES, DESKBY 0930Z ON 23 JANUARY.

BARDER

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January 23, 1989

15 MAJOR DEBTORS
DEBT DEVELOPMENTS
1982-88

Total Debt

- Increased from $386 billion in 1982 to $502 billion in 1988, an increase of $116 billion.

Growth

- Debt strategy (Oct. '85) aimed for 5% growth rate by 1988.

- For the group as a whole, growth improved through 1985-86, but fell in 1987-88. These figures are affected by lower growth in Brazil, Argentina, and Venezuela since 1986. Mexico had negative growth in 1986, very low positive growth in 1987, and declining growth in 1988.

  Average growth for the group as a whole:

	All	Without Brazil
'82	-0.5%	-0.9%
'83	2.7	-3.2
'84	2.3	0.9
'85	3.9	0.9
'86	3.8	1.8
'87	2.4	2.4
'88	1.7	2.3

- For the group as a whole, per capita income declined sharply in 1981-83 and has risen only slowly since then. (It declined in 1988). Standards of living generally are below the early 1980s level. Average per capita growth for the full group:

'82	-2.8%
'83	-4.9
'84	0.1
'85	1.7
'86	1.5
'87	0.1
'88	-0.6

Per capita income data in 1980 local currency units for selected debtor countries:

	1982	1987
Argentina	864	859
Brazil	99	105
Chile	84,930	97,712
Mexico	66,083	58,834
Philippines	5,412	5,058
Venezuela	15,997	14,140

Exports

- Fell by nearly $20 billion in 1986, but returned to 1984 level in 1988 ($126 billion).

	($ billions)
'82	112
'83	111
'84	123
'85	119
'86	99
'87	113
'88	126

Debt Ratios

- Debt/export ratio for the group remains well above 1982 level: it peaked in 1986, but is now improving:

'82	268%
'83	291
'84	272
'85	290
'86	348
'87	337
'88	308

- Debt/GDP ratio for the group is also above 1982; it peaked in 1987, but is now improving:

'82	42%
'83	47
'84	46
'85	46
'86	47
'87	50
'88	47

o Interest/export ratio for the group has improved, but rose in '88 as Brazilian interest arrears were repaid. The ratio for 1989 will be adversely affected by rising short-term interest rates and any repayment of interest arrears (6 of the major debtors now have interest arrears).

Interest/Export Ratios

'82	30.9%
'83	29.2
'84	29.3
'85	28.5
'86	27.8
'87	21.5
'88	26.1

Rising LIBOR rates are of concern (benefit of reduced interest rates since 1985 may be wiped out): Average annual rates during the period were:

'82	13.6%
'83	9.9
'84	11.3
'85	8.6
'86	6.9
'87	7.3
'88	8.2 estimate
current	9.6

New Interest Arrears

	Number of Countries	Amount ($ ml)
'84	4	1,100
'85	3	849
'86	4	1,030
'87	6	5,053
'88	6	2,535

Investment

o Neither investment nor domestic savings have shown much improvement over the period. Investment has declined from an average of about 25% of GDP in 1980-81 to 18% in 1986-88, while domestic savings as a share of domestic income remains near 1982 levels.

	Inv/GDP (in %)	Sav/GDY
'82	22.4	22.0
'83	18.3	20.9
'84	17.9	22.5
'85	18.5	23.1
'86	18.3	21.2
'87	17.7	22.9
'88	18.0	23.3

Exposure by Creditor

- Since 1985, commercial bank debt (expressed as net exposure) has declined by $1 billion, while IMF/IDB/World Bank net exposure has increased by $30 billion.

	Banks ($ billions)	IFIs
'82	245	27
'83	274	36
'84	273	40
'85	281	52
'86	290	65
'87	290	80
'88Q2	280	82

- As a result, there has been a shift in relative exposure; growing IFI exposure as commercial bank exposure declines. This is due to both higher net lending by the IFIs than commercial banks and debt reduction by the commercial banks (the IFIs don't reschedule or restructure debt). Continuation of current trends will accelerate this shift in relative exposure increasing relative risks of the IFIs.

- As share of total debt:

	Commercial Banks	IFIs
'82	64%	7%
'83	67%	9%
'84	64%	9%
'85	64%	11%
'86	62%	14%
'87	58%	16%
'88	56%	16%

o All developing countries' arrears to the IMF and World Bank have been increasing:

	IMF	World Bank
	(ml $s)	
'82	32	20
'83	64	73
'84	182	63
'85	630	86
'86	1,214	325
'87	1,265	630
'88	3,443	1,026

Net Lending

o The debt strategy called for $20 billion in net new lending by commercial banks during 1986-88, roughly equivalent to a 2.5-3% annual increase in commercial bank exposure.

o However, net new lending (expressed as new disbursements minus repayments of principal) in 1986-88 for the full group totaled $9.4 billion, based on country reports. (IMF staff and US regulators are trying to obtain more precise information based on bank reports, which don't now provide these data.)

o Although the World Bank only accounts for 13% of total debt to the major debtors, compared to 57% for commercial banks, its net lending for 1985-87 significantly exceeded that of commercial banks.

Net Lending

	Banks	IMF	World Bank
		($ millions)	
'85	2,500	1,669	2,407
'86	-1,385	-118	3,406
'87	3,646	-1,222	2,420

(In 1988, commercial bank lending exceeded World Bank lending due to the new Brazilian bank package and World Bank reorganization.)

Net Transfers

o If interest payments on commercial bank debt for the group are included, net resource transfers have been negative every year since 1983. Net commercial bank transfers for the major debtors since 1985 are:

	Disbursements	Total Payments	Net Transfers
'85	6.6	31.7	-25.1
'86	4.2	26.9	-22.7
'87	6.2	21.4	-14.9
'88	10.1	26.1	-16.0

Debt Reduction

o Net exposure of banks (as discussed above) actually declined in this period due to debt sales, debt/equity swaps, and other debt conversions. U.S. banks reduced exposure in these countries by $15 billion between 1985 and 1988, largely in the last 18 months.

Annual Debt Reduction

	Number of Countries	Debt/ Equity	Buy Backs ($ millions)	Other Conversions
'82	1	1		
'83	1	452		
'84	2	777		
'85	4	1,266		115
'86	6	1,335		1,071
'87	7	3,559	333	1.5 - 5 bn
'88	9	7,059	300	9,506

Secondary Market Prices

o Secondary market prices (average for the group) have fallen precipitously since early 1987 (triggered initially by Brazilian moratorium and Citibank reserving actions).

o Average market price (as share of face value) has fallen from about 67 cents on the dollar in early 1987 to 39 cents on the dollar at the end of 1988. (See attached graph.)

- The price at which debt has been exchanged for equity in debt/equity swaps in Brazil has also fallen (to about 50 cents per dollar on average during the last auction).

Inflation

- Inflation for the group has advanced dramatically, due in major part to a resurgence of inflation in Argentina, Brazil and Mexico. For the period, inflation was:

'82	55.9%
'83	91.6
'84	118.4
'85	121.8
'86	77.2
'87	116.3
'88	222.9

Fiscal Deficits

- Total fiscal deficits for the major debtors improved temporarily in 1984-85, but have risen again.

($ billions)

'82	5.9
'83	5.0
'84	3.6
'85	3.4
'86	4.8
'87	6.5
'88	5.1

PERSONAL & CONFIDENTIAL

FROM: N L WICKS
DATE: 27 JANUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc EST
Sir P Middleton
Sir T Burns
Mr Lankester
Mr Byatt
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Gieve
Mr Walsh
Mr Tarkowski
Mr Tyrie

Mr Loehnis - B/E

NEXT STEPS ON INTERNATIONAL DEBT

Mulford duly exposed the US Treasury's thinking on international debt at yesterday's G7 Deputies' meeting. He emphasised that Secretary Brady was not committed to the ideas he described, nor had they been cleared with other agencies, let alone the President. They were being considered in the greatest secrecy and there would be enormous embarrassment if news of them leaked out; hence the classification of these papers.

2. The scheme outlined by Mulford involves the use of IFI, especially World Bank and Fund monies, to permit debtor countries to finance the buy-back of bank debt. The G7 Deputies were reasonably sympathetic to the proposals. I was more cautious.

3. The details of the scheme are given in paragraph 7 of the note of the discussion attached. I apologise for its length, but Secretary Brady may well not provide a paper for the G7 meeting, and certainly, according to Mulford, not before you arrive in Washington; hence the detail.

N.L.W.

N L WICKS

WICKS TO CX 27JAN

NSIntDebt

PERSONAL & CONFIDENTIAL

NEXT STEPS ON INTERNATIONAL DEBT

Mulford said that the US Treasury had not completed their review of debt strategy. Brady had had some discussions with the President (before Christmas) and with Baker, but had not cleared proposals with them. Before coming to conclusions, he wanted G7 views. Everything was being handled in the greatest secrecy and he asked us to return the paper he circulated at the meeting which described the background to the US approach.

THE BACKGROUND TO THE US APPROACH

2. Mulford's paper made the following points.

(i) Despite some progress in debtor countries, the debtor nations were tiring of the effort required for reform, though there had been good progress in some countries, such as Chile. The commercial banks were reluctant to provide new finance. They had undertaken a significant amount of debt reduction.

(ii) There were, however, significant problems*. There was a "political perception" that the debtor nations were in as difficult a position as they were a few years ago; policy reforms had not been implemented with sufficient vigour; growth had been too slow to sustain the political will to continue economic reform efforts and to generate new funds; export earnings were not high enough to reduce debt; debt, debt service burdens and arrears had increased; investment had declined by on average 25 per cent; and IFI exposure was increasing as the commercial banks pulled out.

(iii) The outlook was not promising. The prospects were for further partial reforms in the debtor countries which will become more difficult; anaemic growth; continued withdrawal by the commercial banks; increasing involvement by the Fund and the Bank in new lending leading to the loss, perhaps soon, of their preferred creditor status and their eventual need to reschedule; further ad hoc responses which would provided temporary "band

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* Attached are some statistics circulated by Mulford on Debt Developments in the Baker 15.

aids" but no long-term solutions; and harm to the progress towards democracies within the debtor countries.

3. Mulford went on to say that the political interest in the USA in international debt was rising. By 23 February the US Treasury had to submit an interim report to Congress, explaining why it had decided not to proceed with the creation of a "international debt facility". By the same date, the three bank regulators (the Fed, FDIC and Office of the Comptroller of the Currency) had to produce a report on regulatory impediments to debt reduction with recommendations for action (though there was a prospect that this report may be delayed). On 1 March the Treasury had to provide a note for Congress on what the World Bank was doing to facilitate debt reduction following the GCI.

DEPUTIES' COMMENTS

4. My colleagues agreed generally with the gloomy US assessment. Gyohten though that the banks could be persuaded to capitalise interest and to everyone's surprise, he commented that the reality was surely that the IFIs would have to reschedule debt before too long. Trichet, speaking for everyone, said that it would be a "total catastrophe" if the IFIs had to reschedule. He observed a paradox; the banks had already provided for the very action which the debtors' situation required. The need now was for a device whereby the debtors could take advantage of the room for manoeuvre created by the banks. The consequence of present policies was that we were bailing out the banks. I said that we should avoid giving any expectation that whereby 1988 had been the year when Governments had helped Sub-Saharan Africa, so 1989 was the year when Governments would help the middle-income countries. The problems of the two areas were different in nature. Governments were the main creditors in African debt. This was not the case in Latin America. Governments were already making a large contribution, through export credit. Mulford's presentation, and the figures which he had circulated before the meeting, neglected Governments' contribution through export credit. Latin America was not all gloom, as Chile demonstrated.

THE THINKING BEHIND THE NEW APPROACH

5. Mulford then described the new approach under the consideration in the US Treasury. He stressed that Brady was not committed to it and it had not been cleared with the President. The approach would only succeed if it enjoyed G7 support. It was as follows.

(i) The fundamental principles of the debt strategy remained sound: a need for stronger growth and reform in the debtor nations; external financial support; and case by case. Interestingly, Mulford said that "no transfer of risk" was not an original principle of the debt strategy. They certainly rejected any solution which involved providing additional official resources. This would only "finance out" the banks; saddle the debtors with a rising stock of debt; transform the role of IFIs so that before long they would be the major holders of debt, lose their preferred creditor status and have to reschedule. The outcome of providing more official finance would be to place the IFIs in the dangerous position the banks were in in 1982.

(ii) The better approach was to find a solution which placed responsibility for servicing bank debt on the banks and the debtors while giving them incentives at the same time to reduce the stock of debt. This would require legal, tax and regulatory barriers to be removed, and a greater use of the IFIs' policy based loans but in a way which did not insert the IFIs "into the management of the problem". Above all, banks and debtor countries should be encouraged to reduce debt through debt/equity, buy-back etc schemes. This process should take place within the following guidelines:

a. debtors had to be convinced that it was in their interests to reform economies and to undertake policies which attracted new investment and returned flight capital;

b. we had to abandon the pervasive philosophy of "gapology" where public sectors were landed with the task of bridging residual financial gaps. Too often the consequence was that public sectors financed flight capital; debtors were encouraged to exaggerate their financing needs; and the IFIs expanded their exposure effectively financing out the banks;

c. the debtors needed new loans, but only provided that they could be balanced by a reduction in debt service. Interest rate capitalisation, which simply bought time, was a dead end;

d. debtors needed to be encouraged to work intensively with the commercial banks on debt reduction;

e. the approach needed to be attractive to all participants.

A POSSIBLE US PLAN

6. These guidelines led Mulford to describe the following plan.

(i) A medium-term (3 year) perspective should be developed with an emphasis on debt reduction linked to the return of flight capital and new financial flows. The commercial banks would need to give two waivers of restrictive clauses in bank lending agreements which inhibited debt reduction. The first waiver concerned "the sharing provision" whereby banks in a syndicate pledged themselves to share equally payments of interest and principal. Without a waiver this provision exposed a bank selling a loan for cash to the possibility of a law suit from syndicate members after seeking share of the proceeds. Such a waiver had been given in the case of Mexico and Chile. The second waiver concerned "the negative pledge" whereby banks agreed that any security seized by one bank should be applied to the benefit of all banks in the syndicate. (Apparently these two waivers are not needed for debt equity swaps or to exit bonds, but are required for most other debt reduction techniques.) Without such waivers widescale debt reduction would be impossible. So, the first element was for G7 Governments to persuade their banks to give such waivers, where this was necessary.

(ii) The second element was to provide a new source of finance for debt reduction. The IMF and the World Bank could be required to segregate a portion of their fast disbursing money, say between

25-40 per cent, in a special account. This would only be released to the country on evidence that that country had spent an equivalent amount on debt reduction. In Mulford's words, the country would "bring a chit to the window and get reimbursed if they had a real debt reduction plan". He emphasised that the IFIs should be passive players in this process, simply releasing money on evidence of debt reduction; they would not have any role in pricing. The onus would be on the banks and the debtors to devise schemes. Resources provided by the IFIs for debt reduction would be found from within their already planned allocations - there would be no additional money. The IMF would continue its pre-eminent role in ensuring macro-economic conditionality, placing renewed emphasis on liberalising capital markets, encouraging the return of flight capital.

(iii) The approach would encourage the abandonment of "gapology", and focusing the IFIs', the banks' and the countries' attention on debt reduction.

(iv) It needed to be coupled with the removal of legislative, regulatory and tax inhibitions which discouraged debt reduction, an aspect which the US was still exploring.

SOME QUESTIONS

7. The following points emerged in general discussion of Mulford's approach.

(i) There was considerable uncertainty about the attraction to banks of this approach, and in particular whether they would be ready to give the two waivers. Some banks would be ready to contemplate a viable course which removed developing country debt from their books. The problem of free riders was noted. Mulford said that the US Government would be ready to twist the arms of the US banks. The US would consider encouraging banks to participate in the arrangement by altering their tax code so that banks giving waivers could offset foreign losses against domestic income, something not allowed under present tax law.

(ii) There was some feeling that the IFIs would need to involve themselves in the details of debt reduction arrangements more than

Mulford had envisaged. Otherwise there would be scope for fraud and trickery (Trichet). There would be enormous pressure to provide the IFIs with additional funds. A key element in the arrangement was that it would be for the IFIs to decide the proportion of monies segregated, not the country.

(iii) To provide any significant financing relief for the debtors, the scheme would need to be implemented on a massive scale, involving substantial IFI money. There were suggestions that debt/equity swaps were more efficient in reducing debt service than debt buy-back arrangements of the sort envisaged.

(iv) The approach would have two inevitable arithmetic consequences. First, industrialised countries' public sectors, including IFIs, would hold a higher percentage of debtor country debt while the commercial banks reduced their proportion. To that extent the scheme breached the Interim Committee's principle of "no transfer risk to the public sector". Mulford accepted this, but argued that public sector risk would not increase in absolute terms provided the IFIs were not given additional funds. Most important in his view, the approach would avoid the situation which he foresaw whereby the IFIs would be the largest creditors in a few years time. The second arithmetic consequence was that the debtor countries would, in the short-term, be worse off in terms of cash flow since the reduction in their receipts from the IFIs (as a result of the money going to the banks for debt reduction) would initially be greater than the reduction in debt service (as a result of debt reduction). Obviously as time went on this disadvantage would diminish as debt service reductions built up.

(v) Mulford, in his campaign to abandon gapology, would be prepared to sanction Fund programmes where there was a financing gap in the expectation that any arrears would accrue to the commercial banks. Other Deputies, particularly Trichet, were more cautious.

DEPUTIES' FIRST REACTIONS

8. In a tour de table, Deputies gave their first reactions to Mulford's approach.

Trichet (France) - a first very important step in a good direction. Certainly time to concentrate on debt reduction. The IFIs would need additional resources to make the approach work. A priori reservations on the cash buy-back aspect of the proposals because such buy-backs gave less leverage than other debt reduction schemes. An alternative approach would be to concentrate on debt equity swaps. Not ready to abandon gapology since there needed to be an a priori diagnosis whether a country's balance of payments could be financed (to which Mulford replied that gapology simply financed capital flight).

Sarcinelli (Italy) - the scheme deserves all our attention. But there were a number of question marks: what was the incentive for the banks to join the scheme? The reaction of the debtor countries was uncertain and indeed might prompt them to an unhelpful response, like a moratorium.

Dobson (Canada) - the scheme would provide hope, but would not satisfy the creditor countries' expectations. Its advantage was that it placed some of the responsibility back onto the banks. It was open to abuse. But it undoubtedly could change the culture of the debt scene.

Gyohten (Japan) - an interesting idea. He acknowledged a greater role by the IFIs but could not see that the scheme would be attractive to Japanese banks. He made other discouraging noises which conveyed caution, but not much else.

Tietmeyer (Germany) - it would add an additional element to the present strategy, but would not solve the problem. A step in the right direction. Certainly public funds were involved, but they would not be additional. It would help countries improve the structure of their debt. It was essential to avoid any scheme which amounted to the IMF bailing out the banks. He had doubts whether banks and countries would use the scheme to any large extent. The precise role of the Fund and the Bank in the arrangement needed much greater consideration.

Wicks (UK) - agreed with the need to stop the transfer of risk to the public sector and to encourage the banks to play a greater role. Supported truly market based debt reduction arrangements. But was more cautious than other Deputies on Mulford's proposal because it involved a direct use of public funds for debt reduction, it would involve the IFIs and in his view to a greater extent that Mulford had suggested; and would sacrifice important principles of the debt strategy without the prospect of significant benefits for debtor countries unless it was implemented on a massive scale.

9. Summing up the discussion, Tietmeyer said that there seemed to be general agreement that the Baker strategy had run out of steam and that the banks were not providing their share of finance. There was a common position that bankers should be encouraged in debt reduction. Ministers should discuss at their February meeting the Miyawaza and Mitterand plans as well as the approach outlined by Mulford. (It was unclear whether Brady would circulate a paper at the meeting, as the Japanese requested, or would confine himself to an oral presentation.)

[Action: **Mr Evans** to provide an assessment of the approach outlined by Mulford and briefing on Miyawaza and Mitterand plans.]

if.mm/hpe12/30.1 CONFIDENTIAL

FROM: HUW EVANS
DATE: 1 FEBRUARY 1989

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Lankester
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Walsh
Mr Tyrie

Mr Cassell (UKDEL)

INTERNATIONAL DEBT: BRIEFING FOR G7

1. Following our discussion on Monday, I attach a paper which sets out a brief analysis of the position, our objectives, the Brady/Mulford plan, and includes annexes on burden sharing, Japanese and French schemes, and possible World Bank involvement in debt reduction.

2. The section of the paper on "a possible new approach" spells out what might be involved in an effort to enforce better burden-sharing with the banks. Commentators on earlier drafts - especially the Bank of England - are concerned that trying to put pressure on the banks in the ways suggested underestimates the bargaining power of the banks, and risks provoking confrontation from which all might lose, while the emphasis on concerting may run counter to the more market orientated approach that we - and now the Americans - have espoused. Clearly, there is more work to be done.

3. You will want to consider in your Washington discussions how best to make progress before the April meetings. One possibility is to ask Deputies to agree a paper within the next month or so, to help arrive at a common position by April. The paper would contain, for middle income debtors, an analysis of where the debt strategy stands; shared objectives (eg on burden sharing and risk transfer); and options for new, agreed, G7 moves. It might take a particular country or two - Brazil, Mexico, say - and illustrate the options by reference to developments in that country.

Line for the press

4. There is already a considerable danger of excessive expectations being raised in the debtor countries themselves, and a corresponding likelihood of let down in April. Any comments after the G7 meeting - and it is hard to see how these can be avoided given some people's readiness to talk in advance - would be best directed towards emphasising:

- progress so far;
- evolution of strategy (and there is a line here for your April speeches of how the UK has been to the fore in calling for a market-orientated approach);
- flavour of our analysis (need to look again at burden sharing and removing obstacles to debt reduction);
- scope for some further cautious evolution of strategy but wrong to expect major changes.

Problem debtors

5. Mr Mountfield and Mrs Thomson are briefing separately on Argentina, Brazil, Mexico, Nigeria and Poland (minutes of yesterday and today).

H.P.E.

H P EVANS

Attachments

Debt paper

	Annex
Statistics on Baker 15 countries	A
The Brazilian case	B
French and Japanese schemes	C
Waivers	D
World Bank and debt reduction	E

International Debt

Progress so far

1. systematic risk to banking system largely over, though one or two UK banks would be in trouble if there were a mass default;

2. banks have received the great bulk of interest due;

3. main burden of new lending since 1982 borne by public sector;

4. creditors have developed debt strategy through menu approach;

5. debtors have adopted better policies in many cases, but debt burden generally heavier than in 1982, despite improvements in 1987 and 1988;

Debt reductions in some form are now generally accepted as the likely next step for middle income countries. The search is on for mechanisms which allow debtors to take advantage of the room for manoeuvre created by the banks. Evidence that debt reductions likely:

1. banks'provisioning;

2. big secondary market discounts;

3. addition of debt reduction/debt conversion to menu, and increased use of debt/equity swaps and buybacks;

4. poor performance of many debtors' economies;

5. political unwillingness by debtors to sustain current adjustment.

The paradox in the present situation is that while the great bulk of bank debt is now being fully serviced, the message from eg the secondary markets is that at some stage the debt will be much less than fully serviced. The big gap between the market value of debt and its face value will be closed in time either by debtors maintaining a high record of servicing (in which case the market value will rise) or by cancellations or other form of debt conversions.

UK objectives in debt strategy: a framework for the future

Our existing objectives include:-

1. Maximum servicing of official Paris Club debt and continued near full servicing of IFI debts.

2. More adjustment by the debtors, leading to sustainable growth and creditworthiness:

   (i) better macro policies;

   (ii) more private sector involvement through inward investment, debt/equity swaps, privatisation;

   (iii) better use of existing assets, including flight capital.

3. Case by case approach.

Additional objectives, now that the systemic risk to the banking sector is largely over and there is a need to secure better burden-sharing, are:

4. "No transfer of risk from private to public sector". We have interpreted this to mean that the proportionate increase in public sector lending should not be more than the proportionate increase in lending by the private sector, making allowances for debt reduction. This would mean - see Annex A and Annex B on illustrative figures for Brazil - a very big change from current practice.It also means great caution about extra participation by official bodies.

5. Encouraging banks to move from provisioning to cancellation, avoiding the moral hazard of telling the banks to grant debt relief.

The **Brady/Mulford approach** has the following key elements.

(i) removal of tax, legal and regulatory barriers inhibiting debt reduction;

(ii) pressures from governments on banks to grant waivers in loan agreements; and

(iii) finance for market-based debt reduction would come from the IFIs using existing not additional funds.

On (i), the Bank of England's view is that differences in regulatory and tax treatment between countries are not major disincentives to debt reduction, since the markets can allow for these known factors, partly by designing appropriate instruments. On waivers in loan conditions, a Bank of England note is attached at Annex D.

The Brady/Mulford plan also envisages using existing World Bank resources for financing debt reduction eg by replacing some existing policy loans with loans tied to debt reduction. Points to note:

(i) Money is fungible: existing policy loans can indirectly be used for debt reduction, without any formal change.

(ii) A cash flow problem, at least in early years. In the first year, $1 billion of World Bank money used for a policy loan results in $1 billion of extra resources for the debtor. The same amount if used to retire eg $2 billion of debt at a market price of 50 per cent and an interest rate of 10 per cent reduces debt service by only $0.2 billion in the first year, building up in later years. So in the early years, the debtor would need to: adjust more; or have its debt reduction front loaded; or find other ways of filling a financing gap. This problem has led many proponents of debt reduction schemes to advocate extra funds or the use of guarantees by the World Bank. An alternative is to use existing World Bank funds to securitize exit bonds ie a large debt conversion in the first year.

(iii) Many of the banks may refuse to join the scheme.

(iv) To buy back significant amounts of the $280 billion bank debt (of the Baker 15) would require large resources - hence we need to know much more about which countries would benefit, to what extent.

(v) Debt/equity swaps, especially (as in Chile) in conjunction with privatisation, could be an attractive alternative to buybacks. The drawbacks of debt/swaps include elements of subsidy to foreign investors (some of whom would have invested anyway), and inflationary pressures (except with privatisations). The advantages include an impetus to private sector development.

Line to take on Brady/Mulford

1. Useful, market-related, elements here, which can be developed.

2. The plan does not directly address the issues of risk transfer and burden-sharing. What would happen under the plan is unclear but would depend on (a) whether or not extra official funds were made available and (b) how if at all any financing gap were closed. One interpretation of Brady/Mulford is that it implies higher official lending in the short run offset (or more than offset) by lower lending in the longer term. We may get the former without the latter.

3. The plan will lead to pressure for more official funds.

4. Encouragement to banks to grant waivers is akin to persuading banks to participate in new money packages. Little justification for governments to interfere in private contracts.

Japanese/French schemes

These sketchy schemes are discussed in Annex C, which includes the latest version of the French scheme.

A possible UK approach

1. This needs to build on the five objectives spelt out earlier in the paper. Continuing with the existing strategy will lead to a further shift towards the public sector. To limit, or halt, this shift will be difficult, partly because of the bargaining position of the banks, and runs risks both economic and political. But it is worth spelling out what a new approach, with a much greater emphasis on burden sharing, would involve. This approach would maintain many of the features of the existing strategy: case by case determination of the balance of finance and adjustment, incentives for adjustment and private sector development, and so on.

2. Under present procedures, commercial banks tend to get in first, and effectively set the parameters for official sector involvement. The choice facing the official sector has appeared to be: to finance the package or to see it collapse.

3. Changing this would not be easy. It would require:

- a willingness to take on more risk of moratoria/ default
- sustained co-ordination within the official sector, starting from a common definition of our objectives
- a revised sequence of procedures.

4. How could this work? One approach might be along the following lines:

- initial agreement, among creditor authorities especially G7, on how to interpret the Interim Committee principle on no 'transfer of risk'
- negotiations between the Fund and the debtor on a strong adjustment programme
- calculation by the Fund of a financing gap, and thus the relative contributions of the official sector and commercial banks
- communication of these calculations by the Fund to the debtor, official creditors and the banks
- co-ordination, led by the Fund, among official creditors, to establish the precise division of financing among official parties
- in parallel with this, negotiations directly between the debtor and the banks

- subject to the successful outcome of these negotiations, agreement in the appropriate fora (IMF, IBRD, Paris Club, Consultative Groups) on official sector contributions

- sustained discipline within the official sector, to ensure that this policy was not breached.

<u>Some Practical Issues</u>

5. Such an approach might succeed in getting the debtor country to secure a higher contribution from the banks (whether through new money or debt reduction), sufficient to fill a financing gap. That would certainly be our objective. But it may well not succeed. What then?

6. We assume that the Fund will already have negotiated as strong an adjustment programme as is politically viable and economically sensible. We also assume that all other possible sources of finance will have been mobilised. In this case, an imposed limit on official sector finance, combined with a shortfall in commercial bank finance, will result in a financing gap, and the accumulation of arrears. This raises some difficult questions:

- <u>where would the arrears build up</u>?

  It is difficult to say. The debtor may think its priorities lie in staying current with the banks, given the cutback in official sector finance. In this case arrears could accumulate to the official sector (of course at the moment the official sector is simply providing the extra finance anyway). Alternatively the debtor may choose to build up arrears to the banks to put pressure on them to accept more generous debt conversions, or debt buybacks.

- <u>how can the official sector protect its exposure</u>?

  We could try to make Fund programmes (if these went ahead) conditional on the debtor servicing its debt, after taking account of Paris Club rescheduling, to the entire official sector. The commercial banks would of course protest loudly. But this could still leave the Fund exposed. It would be more effective to have comprehensive cross-conditionality across the entire official sector - so that IMF and IBRD disbursements, and new ECA credit, would be suspended if the debtor went into arrears with any part of the official sector. Such cross-conditionality would tend to reduce the credit rating of the World Bank.

- should the IMF programme go ahead?

In the past, we have said that Fund programmes should not go ahead where there are financing gaps. But if we were in a new situation, brought about by the adoption of a burden-sharing policy:

- to refuse to go ahead at the Fund without full financing would lead to the unravelling of previously agreed financing, the probable collapse of the adjustment process, and the accumulation of arrears, probably to both the banks and the official sector.

- this prospect might persuade the banks to reconsider, but it is difficult to judge.

- alternatively, the Fund could (without breaking its Articles) decide to go ahead anyway. The adjustment process would have a chance. The Fund's own position might be protected (to some degree) through cross-conditionality across the official sector.

- the banks would protest - particularly if official sector cross-conditionality looked like being effective. In this case, going ahead with the programme might put pressure on them to reconsider.

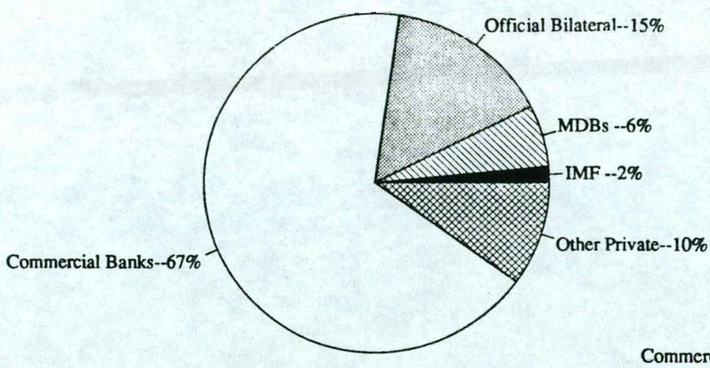
- if the Fund went ahead with an under financed programme, there could be a shambles: eg a confrontation with the debtor, loss of adjustment, and great uncertainty about who gets what.

Conclusion

7. There is a lot more work to be done, on the Brady/Mulford approach, and on the tentative burden-sharing ideas put forward here. There are some tricky conceptual and technical problems involved in putting debt reduction on to the same footing as new money; and in working out how best we differentiate between debtors.

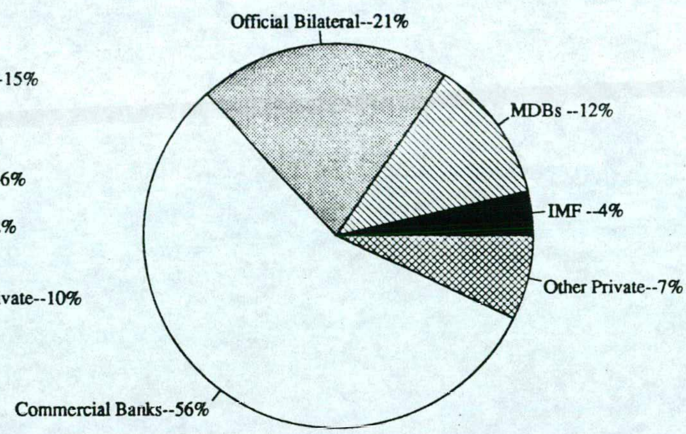
IF
1 February 1989

Baker 15 Countries
Estimated Total External Debt



1982

Total $390 bn



1988

Total $499 bn

	1982		1988	
	$bn	% of Total	$bn	% of Total
IMF	6	2	19	4
Multilateral Institutions	23	6	60	12
Official Bilateral†	60	15	105	21
TOTAL OFFICIAL	**89**	**23**	**184**	**37**
Commercial Banks	262	67	280	56
Other Private	39	10	36	7
TOTAL PRIVATE	**301**	**77**	**316**	**63**
TOTAL DEBT	**390**	**100**	**499**	**100**

† Mostly Export Credit Agencies

Source: Institute of International Finance

Points to Make

1. Between 1982 and 1988 the stock of external debt of Baker 15 countries rose from $390bn to $499bn. Within this total the share owed to official creditors rose from 23 per cent to 37 per cent, while that owed to commercial banks fell from 67 per cent to 56 per cent.

2. Commercial banks have made use of debt reduction techniques, especially in the last two years. It is estimated that the face value of bank debt converted so far amounts to $26bn. Ceteris paribus, as the banks reduce debt their share of the total will fall. However, even scoring the full value of debt converted leaves the banks' share at end-1988 (58 per cent) well below the end-1982 proportion.

ANNEX B

THE BRAZILIAN CASE

The Baseline

The table below shows the expected pattern of net external finance for Brazil over 1988 and 1989, the period covering the SBA and the commercial bank 'new money' package. Given the highly uncertain nature of these estimates, they should only be regarded as illustrative. According to these figures, the official sector is to contribute net $1.5bn to Brazil's external finance during 1988 and 1989, less than the $2.1bn attributed to the banks. (The commercial banks' contribution is lower than the well-publicised figure of $5.2bn 'new money' owing to the repayment of $3.4bn of interest arrears and $0.2bn of other funds (net)).

BRAZIL: NET EXTERNAL FINANCING BY THE OFFICIAL SECTOR AND COMMERCIAL BANKS, 1988 AND 1989

	Total Net Disbursement 1988 and 1989 $bn	Net Flows as % of Outstanding Debt end-1987
Official Sector	1.5	4.5
Commercial Banks†	2.1	2.7

† Includes an estimate ($0.5bn) of the contribution to cash flow from debt conversions

Source: IIF and HMT estimates

2. One problem of interpretation concerns the appropriate starting-point for the calculation of relative contributions: had 1987 been included, the banks position would look better. Another aspect involves the contribution of debt conversions. The IIF estimated the face value of debt conversions in 1988 and 1989 at $6.8bn. Some conversions involve swaps of debt for equity, on which dividends will be paid at some stage, while others involve prepayments of debt (at a discount) and may be financed in part at the expense of 'new money' from both public and private external

creditors. Only part of the effect of debt reduction can be attributed to the banks. We do not yet have a methodology for assessing this. The commercial bank figures in the table use the highly simplified assumption that Brazil's net cash flow gain over the two years from these conversions amounts to $0.5bn, half the interest due on the retired debt.

3. If this cash flow gain is taken into account, the banks' net financing contribution as a proportion of total bank debt outstanding (including short-term debt) at end-1987 is 2.7 per cent. The comparable figure for the public sector is 4.5 per cent. On a strict interpretation of the 'no risk transfer' rule, this would represent an unacceptable increase in the share of the burden falling on the public sector.

Possible Financing Arrangements

4. Using the table above, we can work out figures for what would have been an equiproportional sharing of the financing between the official sector and the commercial banks. This is shown in column (A) below, which shows a reduced official sector contribution, and a correspondingly increased bank contribution. This represents our objective:

$bn	Exposure end-87	Actual Contribution	Hypothetical Contributions (A)	(B)
Official sector	32.7	1.5	1.0	0.9
Commercial banks	80.7	2.1	2.6	2.1
	113.4	3.6	3.6	3.0

5. Column (B) represents, in a sense, the 'fall-back'. If the banks had been unwilling to increase their contribution beyond $2.1bn, equivalent to 2.7 per cent of their end-1987 exposure, strictly equiproportional financing implies that the official sector should have similarly limited its contribution to 2.7 per cent of its end-1987 exposure (otherwise a transfer of risk starts to take place). The result would be an official sector contribution reduced further to $0.9bn.

6. In considering the (B) outcome, the approach we might take would be to leave the net positions of the Fund and the Bank and the gross disbursements (ie voluntary new lending) of official bilateral creditors (mainly ECAs) unaltered: these would be taken as given exogenous decisions. We therefore assume that the reduction in the total official sector contribution is brought about through reducing the <u>involuntary</u> lending of official bilateral creditors, ie through less generous rescheduling of principal and capitalisation of interest. In other words, official bilateral creditors would receive under the new arrangements an additional $0.6bn in the form of repayments of principal or less rescheduling of interest.

ANNEX C

JAPANESE AND FRENCH DEBT SCHEMES

The French scheme

1. The French scheme was floated by President Mitterand at the UN General Assembly in September, shortly after the Berlin meeting of the IMF/IBRD. Many details remain unclear. In outline:

i. There should be a major SDR allocation at the Fund, which could be topped up from other, eg bilateral, sources;

ii. The industrialised countries share of this (64 per cent of the total) is transferred to a separate Trust Fund or to a separate account at the IMF itself.

iii. On a case-by-case basis eligible debtor countries with an internationally approved adjustment programme enter into securitisation deals with the banks to transform their bank debt into either bonded debt or equities. The 17 most indebted countries would be covered, plus up to 10 or 15 others. Eligibility would depend on an assessment of the systemic risk posed by the country and of the need for an international effort to help it manage its debt.

iv. As part of (iii) some or all of the interest or dividend payments on the securities created are guaranteed by the Trust Fund/IMF. The French calculate that an SDR allocation of SDR 15 billion would cover about one year's interest on 40 per cent of the commercial bank debt of eligible countries.

v. To be eligible, the banks, too, would have to agree some form of discount or sub-market interest rate on the interest-guaranteed debt.

vi. Debtor countries would have to repay any guarantee which was called as soon as possible.

Comment

2. Our main objection is the unacceptable transfer of risk from the commercial banks to taxpayers in industrialised countries (despite French claims to the contrary). We also have well known objections of principle to the issue of SDRs. Other major objections are:-

- The potential cost, both directly if guarantees are called and indirectly in adding to world inflationary pressures (contributors to the Guarantee Fund might also have to make interest payments);

- Moral hazard. Interest guarantees would increase the risk of default on debt service unless incentives against default could be constructed;

- Effectiveness. The value to the debtors would depend on the discount they could capture, and the interest rate on the new instruments created. The new bonds would be capital uncertain, so the banks would probably drive a harder bargain than in, eg, the Mexican debt exchange scheme.

The Japanese scheme

3. This was put forward shortly before the Toronto Summit and again during the Berlin meetings. Again, many details remain unclear though it is clear that a global scheme is not intended. The plan merely adds to the existing menu. In outline:

i. The debtor country agrees a medium term adjustment programme with the IMF (probably an EFF);

ii. It then negotiates with the banks to transform a part of the stock of bank debt into bonds fully backed as to both interest and principal; the remainder, which would be partly backed, to be rescheduled on concessional terms;

iii. The negotiations between the debtor and the banks would largely centre on the relative proportions of the two tranches of bank debt and on the terms of the rescheduling applied to the latter;

iv. The first tranche of debt would be subject to guarantee by the foreign reserves of the debtor country deposited, in cash, in an IMF account. The banks would receive bonds drawn directly on the special account which would guarantee that they would be repaid their principal and interest;

v. An agreed proportion of future foreign exchange earnings would be hypothecated to a second account at the IMF which would be used to partially back the remaining portion of the debt, which would be rescheduled at concessional rates.

vi. Separately, Japan would offer an increased flow of bilateral finance (untied Eximbank loans).

<u>Comment</u>

4. The Japanese scheme is less evidently objectionable than the French, but there must be considerable doubt about how effective it could be. The major debtors simply do not have the reserves necessary to achieve the enhancement of a significant proportion of their debts in this way (Mexico might manage $3 billion out of $68 billion). It is hard to believe that the kind of inducement which could be afforded would be sufficient to trigger a worthwhile degree of concession from the banks in the envisaged rescheduling.

5. The main substance in the proposal lies in the parallel financing proposal, which is undoubtedly inspired by Japan's desire for a larger role at the Fund. While no financing from any source should be rejected outright, we have preferred multilateral deals where possible (the Americans are similarly cautious, and have blocked discussion in the Fund Board).

6. A further worry is that there would inevitably be calls for corresponding finance from other G7 countries which would be hard to resist. To the extent that parallel financing assisted debtors to build up reserves in the two IMF accounts, there would also be an indirect transfer of risk from the private to the public sector.

CONFIDENTIAL 26.1.89

ZURICH APPENDIX TO ANNEX C

Handed over by Trichet who asked it to be kept confidential to G7 Finance Ministers.

FRENCH MEMORANDUM

STRATEGY IN THE HEAVILY INDEBTED MIDDLE INCOME COUNTRIES

The current debt strategy has achieved significant results. Among others, it has made possible the implementation of a framework for cooperation between debtor and creditor countries ; it has allowed us to circumvent a crisis of the banking system, and has created, since 1985, conditions favorable to the acceleration of growth in the developing indebted countries.

Nonetheless, the ratio of debt service to exports remains very high, in particular for heavily indebted middle income countries. Moreover, notwithstanding increased reschedulings of the Paris Club, net flows to these countries have sharply decreased in real terms since 1981.

In this context, and after substantial efforts have been made to help the most indebted poorest countries (enhancement of the structural adjustment facility of the IMF, IDA Eighth Replenishment, implementation of the special program of the World Bank, establishment of a new mechanism for alleviating the debt of these countries agreed upon at the TORONTO Summit and recently implemented in the Paris Club...), it appears necessary to improve the efficiency of the debt treatment for the heavily indebted middle income countries which are pursuing an adjustment process. It is indeed in these countries that one can find the largest economic, financial, and beyond these, political risks in terms of international debt.

During the past major international meetings, our governments have recognized the need to improve and diversify the current mechanisms for dealing with debt. This has been done, among others, by encouraging the diversification of debt rescheduling techniques, of new money packages, as well as by encouraging any market-oriented operation based on voluntary negotiations between debtors and creditors.

This is why the President of the French Republic considers that the international community should approach the problem of heavily indebted middle income countries in a responsible and constructive way.

* * *

1) France proposes today to implement a new mechanism which would facilitate the access of heavily indebted middle income countries to financial packages providing for a reduction of external debt, while maintaining their share of responsibilities and efforts in accordance with the debt strategy.

The proposed mechanism consists essentially in the creation of a guarantee fund managed within a multilateral framework. This fund would guarantee the annual installments of interests, dividends or any other form of remuneration to the banks which have agreed to convert, in part or totally, their claims on middle income countries into financial instruments or assets under conditions allowing for a significant reduction in outstanding debt and/or debt service charge.

For instance, if long-term bonds were issued, with the principal being guaranteed by the debtor country, the fund would in turn guarantee the first annual interest installments. The number of guaranteed annual interest payments could vary, based on a five-year average, according, among other criteria, to the value of the claims of the country on the secondary market.

2) The countries targeted by this new mechanism would be the heavily indebted middle income countries, especially those indebted to commercial banks, and which agree to make adjustment efforts under IMF- approved programs.

Two criteria could be used to determine eligible countries : total outstanding external debt and ratio of debt owed to banks over total outstanding debt. The first criterion would assess the risk placed on international equilibrium by the potential insolvency of the country ; the second would measure the need for a specific effort to be made to improve the treatment of claims of commercial banks.

In addition to the 17 most indebted countries, according to IMF and World Bank definition, a small number of other countries - 10 to 15 - could be selected.

The board of the guarantee fund would assess, on a case-by-case basis, the principle and scope of the guarantees granted, after reviewing the situation of the debtor country and in view of the debt rescheduling and reduction schemes presented. Granting the guarantee would be conditional on the adjustment efforts of the beneficiary country ; its nature and scope would be proportional to these efforts.

3) In order to reach the level of guarantee that would be attractive to banks, the amount of financial resources making up this fund should allow for the conversion of a significant part of the debt owed to these banks. Simultaneously it is important that the contributing countries oversee the management of the fund, either directly or through an international financial institution. Finally, one should be able to raise and commit resources for the fund easily and quickly, while maintaining full control over the assessment of needs and risks, as well as over the use of these liquidities.

In order to underscore the multilateral characteristic of the fund, while taking into account the fact that it will be a temporary measure, the creation of this fund could be based on a specific SDR allocation, aimed at improving the international financial situation.

This allocation would be agreed by the IMF's Board of Governors, following its usual rules for voting, and the SDRs would be distributed in proportion to the member countries' quotas. The developing countries would keep their allocations. The share of the industrialized countries (the 24 OECD countries), making up approximately 64 % of the total amount, would be allocated to the guarantee fund. The management of the fund could be entrusted to the IMF, for instance along the lines of the trust fund of the ESAF.

As an example, an allocation of SDR 15 billion would endow the guarantee fund with SDR 9,6 billion. Assuming an average discount of about 30 % for converting the claims and a commitment ratio of 3, in line with the usual provisioning practices of banks, the guarantee fund would manage SDR 110 billion, i.e. 40 % of the debt owed to banks by the countries involved. SDR 9,6 billion would be frozen in the accounts of the guarantee fund as long as the guarantee would not be invoked.

Should the guarantee be invoked, the resulting creation of new liquidities would remain temporary and limited to the amount of the guarantee ; the indebted country would not be discharged of its debt nor of its obligation to repay the guarantee as soon as possible. At the time of repayment, the fund would reconstitute its reserves and progressively eliminate the liquidity previously injected into the world economy. The creation of liquidities could not reasonably be suspected of accelerating world inflation, since their amount would be negligible in terms of the global volume of international liquidities. Furthermore, one must remember that, as all SDRs issued by the IMF, those created by the allocation could be voided when and if the international community considered it necessary.

4) In the interest of efficiency, the guarantee fund could also be allocated other types of resources, in addition to the SDRs. Bilateral contributions by countries, especially indebted ones implementing such debt rescheduling schemes, or by public or private financial institutions willing to participate in a multilateral effort, would be welcome, in the form of direct endowments, annual contributions, or secondary, backup guarantees .

5) The proposed mechanism would offer the following indisputable advantages.

First, it could facilitate the effective implementation of debt reduction schemes, by granting a payment guarantee for the first annual interest installments or, where needed, for the transfer of dividends, which would render such mechanisms more attractive to the banks, among all of the menu options. Consequently, and in view of the number of debtor countries involved, the guarantee fund could have significant leverage.

Moreover, the proposed formula does not discharge either the debtors or the creditors from their responsibilities. Guarantees would indeed be granted only insofar as banks would make a significant effort (by accepting a discount and/or a reduction in interest rates on their claims). Similarly, the granting of a guarantee does not exempt the beneficiary countries from paying their debts or reimbursing the fund, in case the guarantee were activated. Finally, the implementation of this guarantee fund would keep in line with the current case-by-case debt strategy, by strenghtening, on a market-oriented basis, the possibilities offered by the debt reduction options, which are the key element of the mechanism under study.

* * *

The implementation of a guarantee fund by the industrialized countries would thus meet their common interest, as well as those of the most indebted middle income countries, in contributing to the stabilization of the world economy. Endowing this fund with a specific SDR allocation would allow the IMF to fulfill its basic purpose, as defined in Article I of the Articles of Agreement, by dealing efficiently whith the debt problem of middle income countries, which represents an obstacle to the development of world trade.

0975B

ANNEX D

NEGATIVE PLEDGE AND SHARING CLAUSES IN SYNDICATED LOAN AGREEMENTS

1 Syndicated loan agreements typically include standard "negative pledge" and complementary "pari passu" covenants together with "sharing" clauses all of which are intended to give equitable treatment to syndicate members.

2 A <u>negative pledge covenant</u> is intended to prevent a debtor from allocating all or part of its assets or revenues so as to secure the claims of another creditor. Apart from ensuring equal status to creditors of the same class ("same paper, same treatment"), such covenants are intended to dissuade a borrower already in difficulties from granting security to a new creditor. Some covenants also include a provision whereby if the borrower does provide security to another creditor he must at the same time secure the assets of other creditors.*†

3 Some debt reduction techniques (eg the Mexican debt for bands swap which took place early in 1988) involve participating banks agreeing to cancel part of their claims in exchange for a partly secured new asset. The security may be existing assets or a prior claim on a future earnings stream. In the Mexican case the new bonds were to be secured with a portion of Mexico's reserves. The banks that were party to the various syndication agreements were asked to waive the negative pledge covenants so that the reserves could be invested in specially issued US government zero coupon bonds designed to mature at the same time of the new Mexican securities, in effect fully guaranteeing repayment of the principal. That the banks agreed to do so reflects a judgment that on balance, and on a proportional basis, the reduction in the

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* World Bank loan documentation typically includes such a provision.

† In contrast to a negative pledge covenant, which is intended to discourage a borrower from creating a <u>secured</u> class of debt, "pari passu" covenants oblige a borrower to rank all <u>unsecured</u> obligations equally.

debtor's resources available to service the old debt would not exceed the reduction in the old debt as a result of the conversion. In other words securitisation of the new bonds would not undermine the value of each unit of the remaining old debt.

4 "Sharing" clauses typically provide that all payments on the debt be made through a paying Agent who must distribute the receipts pro rata. If a creditor in fact receives more than his share he would normally be bound to hand back the excess for fair distribution. A debt buyback will clearly involve disproportionate payments to creditors selling back the debt[ø]. A waiver will be necessary if the transaction is to go ahead, and was required for the Chilean buyback.*

5 Waivers of negative pledge covenants typically require the consent of the "majority banks" ie those collectively holding more than 50% of the debt covered by an agreement.[†] It should be borne in mind, however, that in a debt reduction exercise many loan agreements may be involved, and it is quite possible that a single bank could hold more than 50% of the debt covered by a particular agreement. Such banks could be in a powerful position to extract concessions from fellow creditors on the debtor.

Experience so far

6 In the Mexican defeasance transaction, and the Bolivian and Chilean buyback, the necessary waivers were eventually given.

ø In the case of debt:equity swaps the agreements typically include a provision whereby the swap is deemed not to constitute a payment on the debt and so is not subject to sharing (or mandatory prepayment) clauses. Such provisions may also apply when foreign currency debt is swapped for local currency denominated claims.

* In Boliva's case the agreement was amended to permit the buyback.

† The required majority may be more than 50%. Chile's original agreements with the banks required unanimous support for waivers permitting debt exchanges and buybacks. The agreements have been amended to allow a 2/3 majority to waive sharing, pari passu and negative pledge clauses so permitting buybacks and a 50% majority to allow assets to be used to purchase the debt.

7 In the <u>Mexican</u> case, some UK banks attempted to make their waiver conditional on the borrower agreeing not to draw the last tranche of new money provided under the 1986 restructuring agreement, arguing that higher export earnings had made the loan unnecessary. In the end, however, they backed off.

8 The <u>Bolivian</u> case was more straightfoward since the banks would only agreed to sanction the transaction if it was financed by donors' funds that would not otherwise have been provided. Their use did not subtract from what little was already available to service the debt.

9 In the <u>Chilean</u> case, (perhaps closest to what is envisaged under the US plan) exceptionally high copper earnings notionally provided the means to finance the buyback. The banks appear to have regarded the buyback as means of bringing forward debt service payments that would probably have been made in future but which might have been lost in financing higher domestic consumption. For those who sold, the loss of the opportunity to receive payment in full was outweighed by the benefit of having cash in hand. Nevertheless, the current and prospective injection of new money (the former by means of a reduction in spreads) at a time when resources were being used to buy in old debt at a discount was unsettling for some banks. Others, however, saw debt reduction as a welcome step forward.

<u>IFI financed debt reduction</u>

10 Some banks might show greater resistance to granting waivers in the case of the use, directly or indirectly, of IFI money for the financing (or guaranteeing) of buybacks (or securitised debt exchanges). The informal senior status of IFI loans (assuming this was maintained) would mean that part of the debtor's resources would be reserved for servicing the IFI claims leaving less to service the reduced stock of bank debt following the buyback. The net effect would be equivalent to the case where a debtor used its reserves to buy in its debt. As in the Chilean case, some banks might see this as detracting from future debt servicing capability and withhold their support, others might prefer to have the cash up front, a third group might not be prepared to sell yet regard debt reduction as the way forward.

Should pressure be put on the banks to grant waivers?

11 There is a close parallel with the process of persuading banks to participate in new money packages. Peer pressure is likely to be more effective in the first instance; some gentle central bank persuasion might also be applied. In a post-Baker Plan world, with the issue of burdensharing likely to come to the fore, recalcitrant banks may be less inclined to follow official signals. Such an attitude would, however, scarely justify more determined official interference in contracts voluntarily entered into by private parties.

Bank of England

1.2.89

ANNEX E

THE WORLD BANK AND DEBT REDUCTION

Introduction

1. World Bank management wishes to play a role in the resolution of the debt problem but, at the same time, is aware of the growing market perception of IBRD arrears (about $1bn) and the fact that declining secondary market prices means that its loans portfolio has a declining market value. They believe that their position as a preferred creditor is reinforced by the fact that they are significant net lenders ($2.2bn in 1987) even though they receive a small net transfer of resources when interest inflows are taken into account. They wish to maintain their leverage as preferred creditors by continuing as a major supplier of finance to the main debtors.

2. The advantages of using the World Bank for financing debt reduction compared to (i) financing by national governments or (ii) the IMF are that:

i. The Bank has preferred creditor status whereas national governments do not.

ii. There is an agreed "key" for capital contributions (and hence risk-sharing in debt reduction) at the World Bank which is more favourable to the UK than that at the IMF in relation to UK commercial bank exposure. But both keys are even more favourable to the US and Japan. (See table below).

Percentage Shareholdings at World Bank and Quota at IMF Compared with Commercial Bank exposure to Baker 15

%

	Commercial Bank Exposure	IMF Quota Share	World Bank Shareholding
US	30	19.91	19.62
UK	10	6.88	5.14
Japan	16	4.69	6.94
Germany	9	6.00	5.36
France	7	4.98	5.14

Resources Available for Debt Reduction

3. IBRD lending (which is constrained by a dollar-for-dollar relationship with its capital) to the heavily indebted middle income countries in FY88 was about $6.8bn, of which about $3bn was in the form of policy-based lending (including both structural adjustment loans and sector lending). Approximately three-quarters of Bank lending is in the form of normal project finance, under which loans from the Bank are invoiced against imports into the country concerned. Only policy-based lending provides some direct cash balance of payments support to the country concerned in return for reform efforts - although even much of this is linked to imports. The amount available for buybacks and other direct balance sheet lending for debt reduction is therefore considerably less than $3bn a year.

4. The World Bank's lending programme is due to increase a little, but it seems unlikely that the amount available for debt buybacks and other debt reduction programmes for middle income countries directly on the balance sheet will exceed $3bn a year. If this funding were used for buybacks at a 50 per cent discount, then the interest saving to the debtors from each year's buybacks might amount to about only (say) $150mn a year.

5. It is the collective view of G10 governments that the World Bank should retain its status as mainly a development institution. This means that approximately three-quarters of its lending will continue to take the form of project finance and only about one-

quarter policy-based lending. Unless there is a major change in this position, therefore, there is very little scope for the World Bank to obtain more resources for the purposes of debt reduction within the existing GCI. To make much of an impact, either the World Bank would have to be given additional capital for this purpose, or the financing gap of the middle income countries would have to be met from other sources.

Types of World Bank Involvement: Risk Transfer

6. Of the mechanisms for debt reduction, buyback involves the most indirect assumption of risk. But the fact remains that loans would be made which would represent the residual value of commercial bank assets - so there would be some indirect assumption of commercial bank risk. In the case of the World Bank collateralising or guaranteeing a debt conversion scheme, there would be a direct assumption of risk of the residual assets to the value of the collateral or guarantee. From the point of view of a static "no risk transfer" principle, therefore, a buyback, a debt conversion scheme, and a guarantee all fail.

7. In the IF debt paper, we argued that the "no risk transfer" rule needed to be interpreted against the background of a secular shift in the relative exposures of the public and private sector, brought about by the withdrawal by the commercial banks from providing new money, and indeed by debt reduction itself. We identified a possible "dynamic" interpretation of the rule for use in assessing the case for **new money** from the official sector. (The World Bank can be treated as a proxy for the official sector).

8. The case for World Bank involvement in commercial bank **debt reduction** can be tested against the same possible rules.

9. The rule we proposed was:

   i. No public sector participation in financing packages involving a net increase in its relative risk. Under this definition, extra net lending by the public sector (including IFIs and other official creditors) as a percentage of its 1988 exposure should not be more than the percentage increase in the net lending of the commercial banks. In cases which involve debt reduction by the commercial banks, the amount of debt service reduction achieved would be taken fully into account by putting it onto a basis equivalent to the provision of new money.

and possibly

ii. In no case should the public sector advance any more money unless the increase in risk thereby incurred was offset by at least an equivalent increase in the mathematical expectation that public sector debt would be serviced or repaid.

10. We look at the case of official involvement in debt reduction:

a. in the light of the rule at 10(i)

b. in the light of the rule at 10(ii)

(a) <u>Official involvement in debt reduction in the interests of better burden sharing</u>

11. The rule at 10(i) attempts to put the objective of more equal burden sharing on a formal footing. In essence it says assistance towards the maintenance of full debt-service should be provided by both the public and private sectors in proportion to existing exposures, or "pari passu". The rule explicitly allows for the commercial banks' contribution to take the form of debt reduction. The "pari passu" rule provides no guidance, though, on whether official participation could be justified, or on the form which it should take.

(b) Official involvement in debt reduction in the interests of managing risk

12. For this we would need a rule along the lines of 10(ii), which says that participation can only be justified if overall it reduces, or at least leaves unchanged, official risk.

13. It is certainly possible in theory for debt buyback schemes to meet this test. Two examples worked out by the Bank of England - both of which improve the NPV of official debt - are shown in the Appendix. The justification for public sector participation would be that the cost would be less than the improvement in the prospects for repayment of the public sector debt. The increase in NPV could partly reflect an improvement in the adjustment efforts of the borrower. This implies that debt reduction assisted by the official sector would require strong conditionality, and that the incentive effects on the borrowers should be studied very carefully. It also implies that official support for debt reduction would have to be on a case-by-case basis.

14. In looking at the advantages of particular mechanisms, we should also look at the alternative possibility of public sector/World Bank support for debt/equity schemes, which have several further advantages over debt exchange/buyback mechanisms, in that they can be linked with the privatisation of state assets, and the repatriation of flight capital, and the fact that the dividend obligations created can vary in line with the ability to generate the funds to meet them (risk-sharing).

Leveraging

15. The capital constraints on the amount of direct on balance sheet funding from the IBRD is one of the reasons why, in the past, the management has usually suggested that its participation in the debt strategy should take the form of partial and selective guarantees for late maturities of principal, or for rolling interest guarantees. Such mechanisms are highly leveraged and

would enable the World Bank to participate in credit enhancement at very little cost to its balance sheet.

16. The World Bank has never issued a guarantee except in the context of new lending, where the maximum amount of the liability taken on has been about $500mn at a future date of (say) 12 years. The net present value of such guarantees is very small. The hope is, through their use, the World Bank can have a catalytic effect by enhancing credit beyond their actuarial value. The very fact that the World Bank is "involved" in a commercial bank loan has probably operated to some extent to give it "senior" status. The same might apply to a guarantee issued in conjunction with a debt exchange scheme.

17. Guarantees under existing accounting rules are charged dollar-for-dollar against the Bank's capital in the period when the guarantee is callable. To obtain even more leveraging, there may be the suggestion that guarantees should go into the balance sheet at less than one for one against capital, or that they should be taken off balance sheet altogether and put in to some sort of special agency or account. All these proposals, while they may be attractive from the point of view of the amount of debt reduction achieved, have the ultimate disadvantage that they increase the contingent liabilities of the Bank and its shareholders (especially those in developed countries).

Conclusions

18. Any large-scale World Bank involvement in the debt strategy must be taken in the knowledge that, if the loans concerned were non-performing, or guarantees were called, the World Bank would have to ask its members to pay in callable capital. There would also be an effect on its borrowing status on world markets, which could mean a substantial rise in its interest rates to its lenders, especially if there were any reluctance on the part of OECD members to pay in callable capital.

19. The World Bank is already heavily exposed to Mexico, Brazil and Argentina (which account for 20 per cent of its existing

exposure) and an enlargement of this exposure would be undesirable. Guarantees would be the most leveraged form of exposure. It would be prudent if the World Bank could restrict any credit enhancement activities to the smaller countries which are having trouble in obtaining new money from the banks - eg Costa Rica.

20. A heavy involvement of the World Bank in the debt problem would mean a change in its status as a development institution. It would also complicate its relations with the IMF, which so far has been in the lead on the debt strategy.

21. So, although well designed debt reduction schemes <u>might</u> enhance the NPV on the Bank's loan portfolio by increasing debtors' long-term capacity to repay, they may not be favoured by the Bank unless pressure is applied by the Americans. However, the Bank is likely to want to expand its non-financial involvement in debt reduction, acting as arranger and referee, and providing ancillary services such as managing funds, issuing bonds for the purpose of collateral; and so on - all of which we can readily support.

APPENDIX

1. Under what circumstances would official creditors benefit from financing the purchase of private sector claims, the benefit being defined in terms of the NPV of expected net cash flows? Two case might be distinguished, and are illustrated in figures A and B:

- In official creditors' eyes the debtor is solvent but the banks do not share this view or are unwilling in the short run to capitalise a sufficient proportion of the interest due to them.

- The debtor is insolvent. A sufficiently large buyback could reduce the debt to a sustainable level, particularly if the reduction in the contractual value of debt increased adjustment incentives.

2. In the first case (figure A) the debtor is solvent but cash-constrained. The debt:export ratio before the buyback is declining but is still too high to induce the banks to lend. Official creditors are effectively lenders of last resort and the ratio of official debt to the LDC's exports rises steeply until period 11. At that point the debt:export ratio has fallen sufficiently to induce other creditors to lend. Thereafter official exposures ratios begin to decline.

3. Buybacks financed by official creditors could accelerate this process. Assuming some debt could be purchased at a price below par (there must be sufficient myopia/uncertainty amongst banks that some are willing to sell at a discount), the debt:equity ration would shift down and private creditors would begin to lend earlier (in the example, around period 6). Official exposure would initially rise faster than in the pre-buyback case but would reach an earlier and lower peak before declining. In terms of the NPV of net cash flows (interest payments less net lending) official creditors would gain.

4. In the second case (figure B) the debtor is insolvent. Its debt:equity ratio is steadily increasing and official exposure (reflecting the lender-of-last role) is exploding. The effect of the buyback leads to a sharp, step reduction in the debt:export ratio (the price is much lower than in the solvent case so more debt is purchased) and, possibly, to an improvement in the economic performance by the debtor. The buyback is also sufficiently large to reverse the trend in the debt:export ratio. It eventually falls to a level that triggers a resumption of private lending. From that point (around period 15) the official exposure ratio declines. Compared with the solvent case, it is a longer haul but again the NPV of net cash flows received is higher than before the buyback.

Figure A

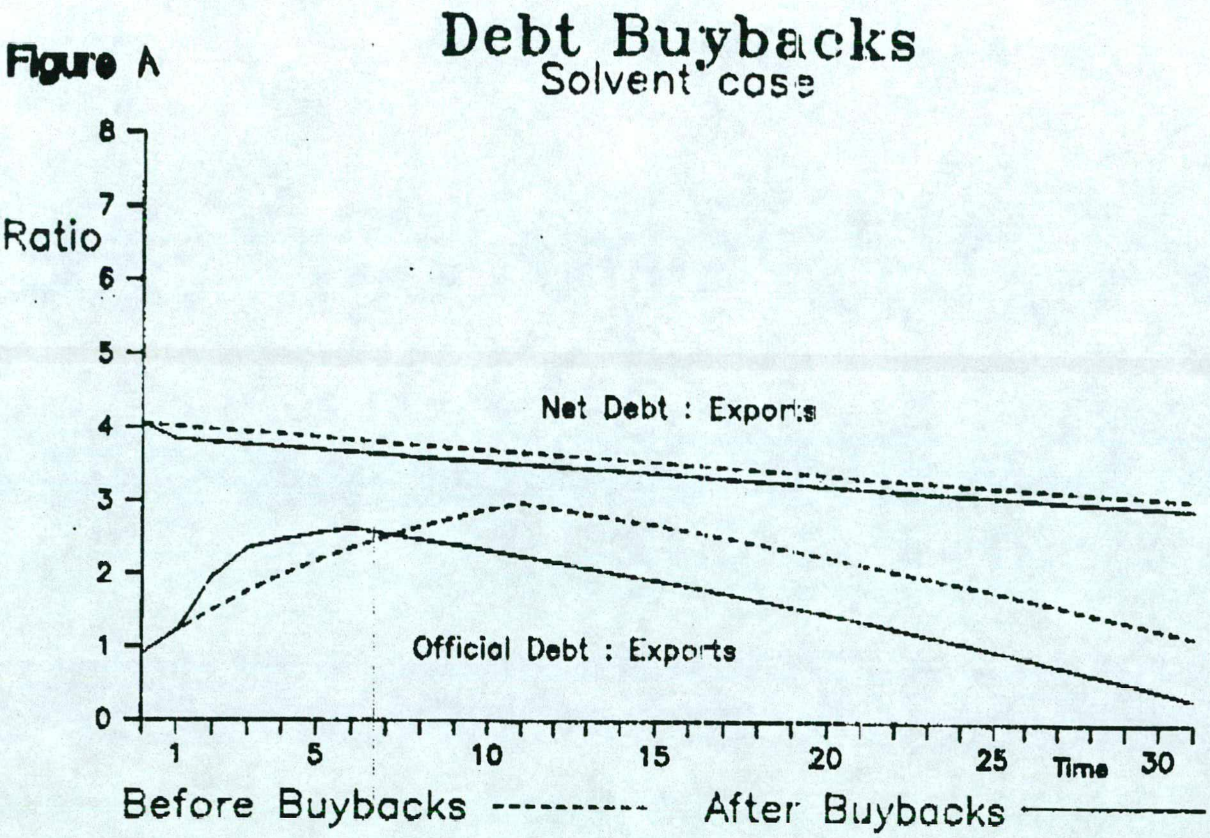
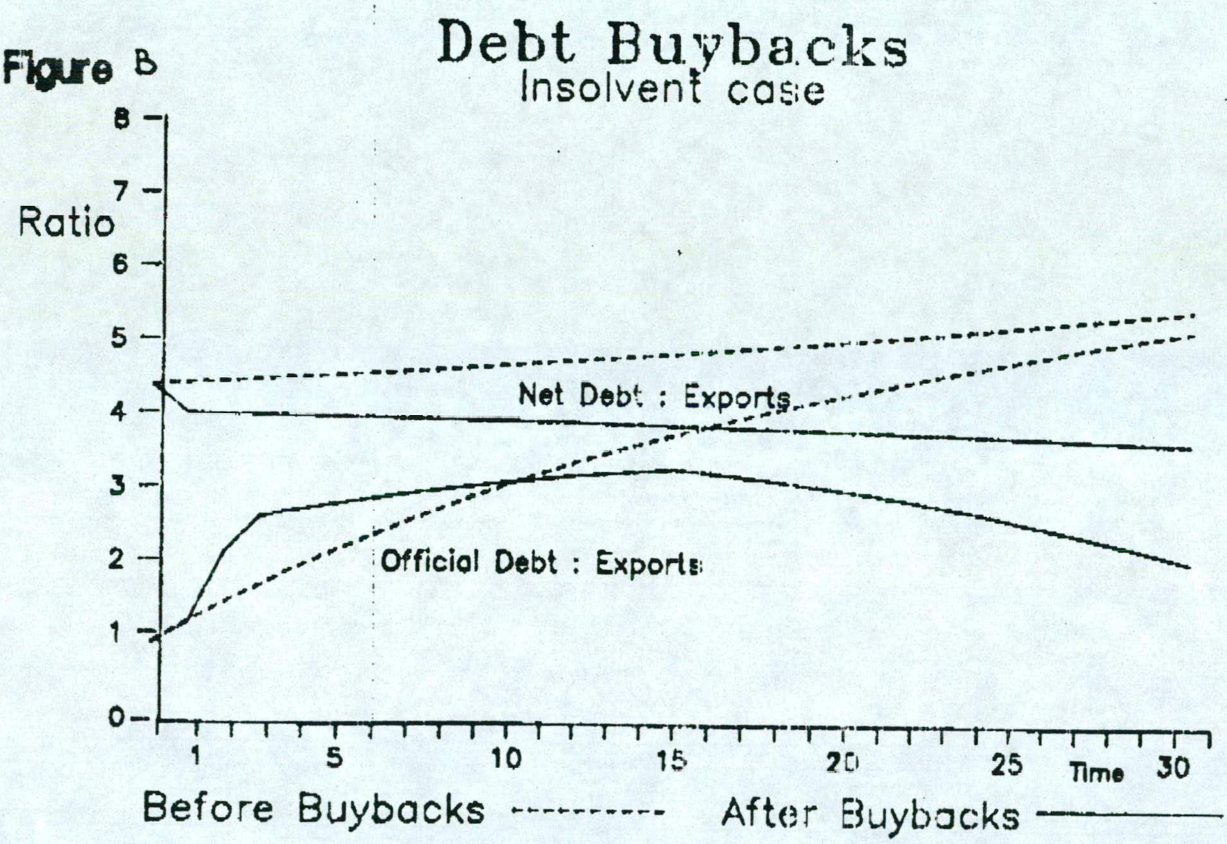


Figure B



CC: PS/EST
Mr Wicks
Mr Lankester
Mr H.P. Evans
Mr Mountfield

✓ 14/2

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 February 1989

Dear Alex,

VOLUNTARY DEBT REDUCTION

I enclose a copy of a note which Dennis Weatherstone, President of J.P. Morgan, recently gave the Prime Minister containing proposals for voluntary, market-based debt reduction. You may find it of interest if you have not already received it from elsewhere.

I am copying this letter and enclosure to John Footman (Bank of England) and Stephen Wall (Foreign and Commonwealth Office).

Yours sincerely,

Charles Powell

(C. D. POWELL)

Alex Allan, Esq.,
HM Treasury.

JPMorgan

Morgan Guaranty
Trust Company of
New York

PO Box 161
1 Angel Court
London EC2R 7AE
Tel: 01-600 2300

VOLUNTARY DEBT REDUCTION

Voluntary market-based debt reduction constitutes a viable and effective mechanism for reducing, on a case by case basis, the external debt costs of LDC debtors who are adhering to sound economic policies. The first significant transaction of this type was announced by Mexico and J.P. Morgan on December 29, 1987.

The Mexican Debt-for-Bonds Exchange

Mexico offered to its bank creditors a voluntary exchange under which lenders tendered in an auction, at a discount from face value, their existing loans to the public sector for newly issued 20-year bonds whose principal was secured by 20-year obligations of the U.S. Treasury. Mexico purchased the U.S. Treasury obligations used as collateral directly from the U.S. government using its international reserves.

The bonds have a single final maturity 20 years after the date of issuance and bear interest at a floating rate equal to the London Interbank Offered Rate (LIBOR) plus 1 5/8%. The payment of principal of the bonds at maturity is secured by U.S. Treasury zero-coupon bonds having a face amount equal to, and maturing on the same date as bonds issued by Mexico. This means that the repayment of the Mexican bonds in the year 2008 will come from the proceeds of the maturing U.S. Treasury zero-coupon bonds whose purchase price in 1988 was about $19 per $100 of face value.

The transaction provided banks with an opportunity to improve the quality of the Mexican public sector debt in their portfolio by receiving a better asset with the following characteristics:

1. Principal repayment of the bonds is assured.

2. The bonds carry a higher interest rate than existing bank loans.

3. The bonds are likely to be more marketable than bank debt.

4. They will not be rescheduled.

5. Holders of the bonds will not be asked by Mexico to participate in any future involuntary new money programmes, as regards those obligations.

In exchange for these benefits, banks were asked to tender their existing loans at a price below face value, thereby incurring a loss.

For Mexico, the transaction resulted in a reduction of the level of its bank debt and debt service, and at the same time assured repayment in the year 2008 of the principal amount of the new securities issued.

The U.S. government did not incur any costs in connection with its provision of U.S. Treasury obligations as these were sold to Mexico at prices slightly above market levels.

Mexico received bids totalling $6.7 billion from 139 banks in 18 countries. Bids for $3.7 billion were accepted, at an average bid price of 69.77 cents per dollar. Banks incurred losses averaging 30% of the face value of the old debt tendered. Mexico issued $2.6 billion of new bonds to banks whose bids were accepted. As a result, the transaction reduced Mexico's outstanding debt by $1.1 billion and will save Mexico about $1.5 billion in interest payments over the life of the bonds.

While the transaction achieved some of Mexico's goals and introduced a new technique that can be used to address the debt problems of developing countries, the size of the transaction was not as large as Mexico would have liked. A number of factors influenced adversely the willingness of banks in different countries to participate, including complex and varying regulatory and accounting issues. However, the principal drawback expressed by bank lenders was the lack of security on interest payments of the new bonds, which continued to be 100% Mexican risk.

Full or partial security on interest payments would have lowered the Mexican risk component of the new asset, thereby making it more valuable to banks. A more attractive asset would yield more positive results in terms of eliciting a greater volume of debt tendered as well as a larger discount from face value than that attained in this first effort.

The Way Forward

Enhancement of interest payments would make this type of transaction more effective in reducing the debt burden of LDC debtors carrying out sound economic policies. One way to provide interest security is for the LDC debtor to purchase additional collateral, for example in the form of U.S. Treasury securities, to back the interest payment flows. By and large however, collateralization of this type is not feasible since even LDC debtors with good performance face a foreign exchange constraint. Accordingly, the size of the transactions that could be carried out on this basis would be small, and consequently, yield little benefits in debt reduction, unless loans from multinational organizations could be used to supplement collateral purchases.

Third-party guarantees on the interest flows of the new securities offer the most promising alternative for enhancement. Guarantees can be constituted at a fraction of the cost of purchasing collateral, and can be priced in line with the risk characteristics of individual countries. Moreover, the guarantees need not cover 100% of the interest payments over the life of the new security but could be structured on a rolling basis. An initial three-year rolling guarantee, for example, could move forward to cover interest in years 2 through 4 after the initial year's interest payments have been made, and extended in this fashion throughout the life of the security unless or until the guarantee is exercised. The guarantor's total liability would be limited to three-years' worth of interest payments.

The most obvious sources for the provision of these guarantees or the financing of collateral purchases would be the multilateral organizations such as the World Bank and the IMF, and to a lesser extent, their regional counterparts such as the Inter-American Development Bank and the Asian Development Bank. These institutions enjoy the financial backing of all member governments, they are knowledgeable about the LDC's economic performance, they have a mandate to promote balance of payments stability and economic development, and they recognise that voluntary debt reduction of commercial bank debt can contribute to those objectives, and improve the quality of their own loans to these countries.

The claims that voluntary debt reduction with interest security could put on the capital structure of these entities could be controlled in a number of ways. Firstly, by earmarking a specific portion, say 5 - 10%, for such transactions. Secondly, access to guarantees or financing for collateral would be managed through conditions to access which required prior demonstrated economic performance, rather than the announcement of an economic program, even if backed by these institutions. Thirdly, the provision of guarantees or of financing for collateral would carry financing costs in line with those currently in place in these entities. Finally, the participation of these entities in support of these type of transactions will not require additional financial contributions or budgetary allocations from member governments.

Mexico as a Test Case

The LDC debt problem is long-term in nature owing to the need for these countries to effect consistent, sound fiscal and monetary policies, as well as major structural changes in areas like trade incentives, the tax system and the pricing structure.

Such changes require sustained effort and can have a major impact on society albeit putting great demands upon the political system. Each country has different natural and human resources. Each has different social and political structures. Each has its own vulnerability to external factors. As a result each requires solutions tailored to its specific circumstances.

Mexico has made significant progress over the last several years. It has moved aggressively to open up the domestic market to international competition, has stimulated non-oil exports to record levels, has taken important privatization initiatives and is currently embarked on an ambitious program to bring inflation down to less than 20% per annum.

Mexico's recent performance and the prospects for continuity under President Salinas' administration stand in stark contrast to those of the other two major LDC debtor countries - Brazil and Argentina. In these countries, the promise of substantial resource endowments have been negated by lack of policy consistency and a recurrent failure to address fundamental economic distortions.

Depending on the level of interest security and the amount of collateral financing available, Mexico could reduce its bank debt by as much as 35%. Mexico, thus, represents a significant opportunity to utilize the debt exchange mechanism with interest security to achieve a meaningful reduction in its debt level, as well as to provide a strong stimulus to other LDC debtors to adopt and sustain sound economic policies.

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FROM: J M G TAYLOR
DATE: 21 February 1989

MR LANKESTER

cc Mr R I G Allen
Mr H P Evans
Mr Mountfield

IMF PRESS SUMMARY: EC AND LDC DEBT

... The Chancellor has seen the attached extract from the IMF Press Summary.

2. He has commented that, if it is true that the EC may be relenting in its refusal to discuss LDC debt, this must be stifled.

J M G TAYLOR

BANK OF JAPAN MAINTAINS NEUTRALITY AS REST OF G7 TIGHTENS. AP-DJ said in a Tokyo report that Japan's G7 allies are mostly tightening monetary policy, but the Bank of Japan's stance is scrupulously neutral, if not a bit on the easy side. Stern reminders from Bank officials of the importance of stable prices and overseas interest rate increases keep Japanese investors nervous while dragging yen bond yields higher. But short-term interest rate rises have been minimal and the Bank has been generous in supplying reserves to meet market needs.

U.S. TREASURY WILL NOT MEET DEBT REPORT DEADLINE. WP, pB3, reported from Washington that a senior U.S. official said the Treasury has told Congress it will be unable to meet the Feb 23 deadline for an interim LDC debt report. But separate reports from the FDIC and Comptroller of the Currency on possible revised bank regulations to promote LDC debt reduction will be made on time. Congress agreed to an extension of about three weeks of the legal deadline for the debt report. A senior official, probably Under Secretary David Mulford, will outline Treasury views on LDC debt issues to a Senate Banking subcommittee then. Treasury will formally rule out creation of an international debt management authority, to resolve the LDC debt problem.

EEC SHOWS SIGNS OF RELENTING ON DISCUSSION OF LDC DEBT. Reuters reported from Brazzaville that the EEC indicated it may be relenting in its refusal to discuss LDC debt, with Development Commissioner Manuel Marin telling a news conference that debt will be on the agenda of EEC ministerial talks in March, and again in June. He gave no details of what measures would be discussed, but said the inclusion of debt on the agenda is an important move, and almost unprecedented. The agency commented that the EEC, currently negotiating a pact to succeed its Lome Convention for aid and trade with 66 African, Caribbean and Pacific LDCs, had resisted pressure to persuade individual EEC members to wipe out much of the $140B debt of the ACP countries.

SARNEY HINTS FINANCING NEEDED FOR DEBT PAYMENTS. WSJ, pA10, reported from Brasilia that Brazilian President Jose Sarney told Congress the country's $115B debt burden is intolerable and indicated Brazil will not be able to maintain foreign debt interest payments if it does not get foreign financing soon. The paper said the international debt situation is likely to catch fire again, if Brazil, the largest LDC debtor, stops paying interest. Brazilian debt fell 7c to 30c on the secondary market after Sarney's remarks. WP, pB1, reported Sarney said Brazil does not have the money to make March debt payments to creditor banks and the IMF. Last September's loan agreement with commercial creditors will have to be revised, he added.

Revised 2/23/89

CASE STUDY: MEXICO
(3-YEAR TIME FRAME)

NEW IFI PROGRAMS:

o 3-year program of using 25% of annual IMF and World Bank lending to facilitate debt reduction, assuming:

-- IMF and World Bank loans for 3 years: $7.5 billion
of which 25% for debt reduction: $1.88 billion

-- 25% for cash buybacks at a 50% discount; and 75% for collateralization of principal over 30 years at a 40% discount

o IMF/World Bank backing of interest payments for 1-year on:

	IFI funds
-- collateralized debt reduction	$1.87 billion
-- debt restructuring with interest rate reduction	$0.75 billion

BENEFITS TO MEXICO OF:

o $31.1 billion of debt exchanged at 40% discount and collateralized:*

total debt reduction	$12.44 billion
interest relief over 3 years	$2.49 billion

o $0.94 billion debt in cash buybacks at 50% discount:

total debt reduction	$0.94 billion
interest relief over 3 years	$0.19 billion

o Mexican debt/equity swap program of $2 billion per year:

total debt reduction	$6.0 billion
interest relief in 3 years	$1.2 billion

o $15 billion restructuring*, interest reduced from 10% to 5%:

total debt reduction	$0
interest relief in 3 years	$2.25 billion

o Total impact of debt reduction:

total debt reduction	$19.38 billion
interest relief in 3 years	$6.13 billion
debt extinguished (30 years)	$38.0 billion
old debt* affected during 3 years	$53.0 billion

*includes debt + I.r. reduction

* Backed by interest support fund.

POTENTIAL IMPACT ON MEXICO OF NEW PROGRAMS ($BILLIONS) 2/23/89

CHANGE IN STOCK OF DEBT: MEXICO

BEGINNING DEBT	$104
NEW IFI LOANS	$8
DEBT REDUCTION	($19)
DEBT PRIOR TO OTHER NEW LOANS@	$92
NET CHANGE	($12)

ESTIMATE OF FINANCING NEEDS: 1989-91

CURRENT ACCOUNT DEFICIT	($12.5)
CAPITAL ACCOUNT DEFICIT	($10.9)
INCREASE IN RESERVES@@	$0.0
ESTIMATE OF NEEDED FINANCING FLOWS	($23.4)

INTEREST SAVINGS FROM NEW DEBT PROGRAMS	
COLLATERALIZATIONS AT DISCOUNT*	$2.5
RESTRUCTURINGS REDUCING INTEREST	$2.3
DEBT EQUITY SWAPS (NET REPATRIATED PROFITS)	$0.9
CASH BUYBACK*	$0.2
TOTAL	$5.8
NEW IFI LOANS**	$5.6
FOREIGN DIRECT INVESTMENT	$3.0
ROLLOVER OF PRINCIPAL DUE IN 1989-91	$4.6
ADDITIONAL EXPORT FINANCING	$1.8
TOTAL FINANCIAL SUPPORT	$20.8
REMAINING FINANCING REQUIREMENTS	($2.6)
RETURN OF FLIGHT CAPITAL	$1.5
OTHER NEW MONEY***	$1.1

@ This figure will be increased by new official bilateral and commercial bank lending.

@@ Mexico will incorporate reserve build-up in its demands, but commercial banks will resist it and IFIs and creditor governments should not finance it. The build-up could be financed by new investment and return of flight capital.

* Debt reduction funded from 25% of IFI loans.

** Remaining IFI loans, net of debt reduction set-aside.

*** Options: cofinancing, trade deposit facility, bonds, direct investment by banks, or on-lending.

FROM: HELEN WRIGHT
DATE: 24 FEBRUARY 1989

MISS WALLACE ✓

CC. Mr Mowl

NET PUBLIC SECTOR DEBT

You asked for some information on net public sector debt. Net public sector debt is measured at the end of each financial year and figures are available from end-March 1975.

2. Net public sector debt was 38.6 percent of GDP at end-March 1988. At the moment we have only a guestimate figure for end-March 1989 of 31 1/2 per cent of GDP. We are currently working on refining this figure. We do not have a figure for end-March 1990.

3. Net public sector debt as a percentage of GDP for end-March 1988 is the lowest since records began in 1975.

4. For international comparison purposes we use general government debt. I attach a rough table showing international comparisons of debt. The figures have been extracted from the OECD Economic Outlook.

Helen Wright

HELEN WRIGHT

Thanks.
1975 is rather recent.
What debt (stock) do we have
going back further? Net gen
govt debt? Anything relevant?
2. In table (ii) now, PSBR
let me have figs for
EC excluding UK.

(ii) Net general government debt[1] as percentage of GDP*

	1975	1979	1983	1987**	1988***
UK	57	49	46	43	39
US	24	19	25	30	30
JAPAN	-2	15	26	26	25
GERMANY	1	12	21	23	24
FRANCE	11	10	20	27	27
ITALY	60	64	69	89	92
CANADA	4	11	21	36	37
G7 AVERAGE	20	21	28	33	33

Source: Economic outlook December 1988

(1) Net of assets

* rounded to nearest 1 per cent

** Partly estimated by OECD

*** OECD forecast

CONFIDENTIAL

From: T P Lankester
Date: 24 February 1989

MR J M G TAYLOR

cc

Mr Wicks
Mr R I G Allen
Mr Evans
Mr Mountfield
Ms Symes

NBR

EC AND LDC DEBT

In your minute of 21 February you mentioned that the Chancellor had seen an extract from the IMF press summary referring to a report that the Spanish Commissioner, Marin, has said that the EC intends to discuss LDC debt. The Chancellor commented that this must be stifled.

2. The Spanish have pretensions in the debt field and have come up with their own expensive and half baked debt scheme for the middle income debtors. At the February ECOFIN lunch they managed to secure agreement that the Commission should prepare a discussion paper on this subject. It looks as if the Spanish Presidency want this discussed at the March ECOFIN, and that they also want to have a discussion at the Madrid Summit in June.

3. This is, to say the least, unfortunate. But I do not think there is any way we can now stop the Commission from producing a paper or from keeping it entirely off the agenda at the March ECOFIN. What we will do is try to persuade the Commission - we will be seeing their representatives at the SHERPA meeting over the weekend - to keep the paper to essentially a background note rather than attempting any kind of EC position paper. We will then need to pour as much cold water as possible on EC involvement in the debt strategy at the March ECOFIN, and then counter Spanish ambitions to have this on the agenda at the Madrid Summit.

E. Davies

pp T P LANKESTER

chex.ps/jmt/25 **UNCLASSIFIED**

FROM: J M G TAYLOR
DATE: 27 February 1989

MS H WRIGHT

cc Mr Mowl

9/3

NET PUBLIC SECTOR DEBT

The Chancellor was grateful for your note of 24 February.

2. He has asked which debt series we have that goes back further than 1975 (he suggests "net general government debt"). He would be most grateful for advice on this. He would also be grateful if the G7 figures could be reworked in the table to show the G7 excluding the UK.

J M G TAYLOR

G7 DEPUTIES - PARIS, EVENING OF SUNDAY 26 AND MORNING OF MONDAY 27 FEBRUARY

INTERNATIONAL DEBT

The meeting began at 19.00 in the Ritz Hotel.

2. Trichet (France) in the Chair, asked Mulford to report the US latest thinking.

3. Mulford said that the US had developed its thinking since the Washington meeting, so that their approach now included an interest relief dimension. It was important, for domestic political reasons, not to give any impression of "large" additionality of resources, though there might be "some". Secretary Brady had spoken to Camdessus (Fund) and Stern (Bank). To succeed, the approach would need a considerable degree of consensus among G7 in order to persuade the Fund and the World Bank to introduce the changes. He emphasised that strict security had been maintained in Washington on the US proposals. A few bankers had been consulted. Secretary Baker knew the broad outline and was generally happy. The President knew something, but not the details. The Fed, except for Greenspan, was pretty much in the dark. Only a few in the Treasury knew what was going on.

4. Mulford then described the US approach in the following terms:

(i) The banks should give waivers on their sharing and negative pledge provisions to good performing countries. The banks' waiver would be conditioned to come into effect when a Fund programme became operative. Mexico and Venezuela were the obvious countries to qualify for the US approach. The waiver might last for three years. The banks would need to negotiate among themselves in order to protect themselves in the event of having to provide new money loans. His consultations with US banks (Rhodes and Wagner were later mentioned) suggested that the US approach was feasible if it had the support of G7 countries.

(ii) Two types of debt buybacks were envisaged:

a. Cash buybacks. Banks which no longer wished to participate in sovereign lending would be interested.

b. Debt swaps. These provided better leverage and could be modelled on last year's Mexican scheme.

Finance for these arrangements would be provided by the IFIs (Bank and Fund); for example the Bank would set aside 25 per cent of its policy lending for a specified country and the Fund would set aside 25 per cent of planned disbursements to that country.

(iii) Separate from the set aside approach in (ii) above, the Fund and the Bank would each establish pools of money which would provide security for guaranteeing interest payments by debtors to banks. The pools would be constituted from the IFIs' general resources and not from lending allocated to any particular country. (He was unclear how this would reconcile with the Fund quota and access arrangements.) The pools would be used to guarantee one year of interest payment for collateralised debt swaps. The guarantee could, depending on the precise nature of the arrangement, be rolled forward for the entire length of the collateralised loan - which Mulford suggested might last 30 years - or for only a limited period. The effect of the arrangements would be that creditor banks would be eligible to receive from the Bank and Fund pool one year of interest payments, but no more. This limit of one year would provide the country and its creditor a breathing space to sort out the economic difficulties which caused by the cessation of interest payments. Intrinsic to this scheme would be the agreement by the banks to reduce the level of interest payments, by say a half. Countries would only be eligible to receive the "pool" guarantee for their interest payments if they accepted debt reductions.

(iv) The arrangements described above would not involve any additionality in the sense that neither the Fund nor the Bank would be given extra resources. The set aside money would come from normal loans/disbursements and the pool money would be constituted from within existing resources. However, countries benefiting from the pool guarantee arrangements would have, effectively, received additional support. Eligibility from the pool would be allocated on a first come, first served basis with the expectation that the good performance of Mexico and Venezuela would put them at the head of the queue. In practice, money would flow from the guarantee pool only to the extent that guarantees were called. At the end of three years the unspent portion of the pool could be returned to the Bank's general resources and lent out in the normal way (unless the pool arrangement was continued for another three or so years).

In later discussion, it was pointed out that to the extent there were no additional resources for the IFIs and certain countries benefited from the pool, other countries would lose. Which countries would be affected and how would the reduction of resources for which they were eligible be calculated? Mulford had no satisfactory answer to this point except that this consequence was essential to any scheme which tilted Bank and Fund lending to good performers.

(v) The design of Fund programmes would be changed so that they gave new emphasise to stimulating inward capital flows, for example through private investment and the repatriation of capital flight. Eligible countries would have to have practical and effective debt equity swap programmes.

(vi) Mulford laid great emphasis on the need to change the psychological climate and procedural arrangements for agreeing bank financing packages. There was a good possibility that some banks, for example those with a long term interest in the debtor country, would agree to provide new money, though such banks would not be many. Banks might seek some enhancement, in the form of World Bank guarantees, co-financing and sharing provisions for new money packages.

5. Mulford then handed round the note attached which gave a broad outline of the effect of the approach described for Mexico.

6. There was then a preliminary tour de table:

<u>Gyohten</u> (Japan) expressed basic support, but was unsure how Japan's tax and regulatory rules would affect the proposals'

feasibility. It was important that the debtors should deliver in return improved economic performance.

Dobson (Canada) also expressed basic support. She was concerned about the proposals' consequences for the role of the Bank and the Fund, especially the operation of the "pools". The scheme would be well worth doing if it gave Mexico and the other deserving debtors a real chance.

Sarcinelli (Italy) welcomed the interest relief option. He could not agree with the implication in Mulford's presentation that Governments should put pressure on the banks to take advantage of the proposals. The banks themselves had to decide. He suspected that some banks, especially the smaller ones, might not welcome the proposals.

Wicks (UK) said that the scheme was worth considering. He agreed with Dobson that role of the Bank and the Fund needed careful scrutiny. It would be important to see how the pools were constituted; which countries would lose out? The successful operation of the arrangements would need tight organisation and discipline among the creditor countries. He suspected that it would be unpopular with many developing countries who would feel it favoured particular countries.

Tietmeyer (Germany) thought that the general idea was right, though the scheme clearly needed further examination. He saw difficulty if the early beneficiaries of the scheme were only countries closely linked with the United States. He supported the idea of helping good performers. He was unconvinced that an IMF pool could be constituted without a quota increase. He thought that the German banks would go along with the proposals. Tax considerations were important, though probably not a problem in Germany. The approach went in the right direction and it would generally have his support.

Trichet (France), after commenting that this was a "historic moment", said that he could go along with the scheme. Certain questions, however, needed to be answered: the relationship with the export credit agencies and the Paris

Club; taxation considerations; the effect on the banking community and the possibility that the scheme may reduce the moral pressure exercised (at least by France) on banks to continue lending. He thought that the proposals should be agreed quickly.

7. Mulford then said that the US Treasury had to provide their delayed report on a debt facility to Congress by the middle of March. Congressmen had made it clear that the Treasury should not provide a report and then announce a new scheme at the Interim Committee. The Treasury also wanted more formal consultations with the banks and the Fed. All this suggested to the US Treasury that their proposals should be announced, probably in a speech by the Secretary, before the mid-March Congressional testimony. More details could be given in a detailed working paper.

8. Tietmeyer understood the US's political problems. But the US should say nothing which suggested that G7 were committed. But they could say that G7 had been "consulted". Gyohten insisted that the US should present their approach as their own plan. They should not say that they had "consulted" G7 since this gave some sense of G7 approval. The US should make it clear that their approach incorporated elements of other ideas which had been put forward. Agreeing with Gyohten, Wicks said that the US might indicate in their announcement, if they had to make one, that G7 partners had been informed about the development of their ideas. He doubted whether the British Government would wish to give any commitment at the early stage of the announcement. Our public line might be that the we were aware of the US proposals, would study them with interest, and that their discussion would no doubt feature prominently at the Spring Meetings. Mulford pressed that this Secretary should say that his proposals had "general agreement" and G7 agreed that they represented a significant development. Tietmeyer and Wicks said "no".

9. In further discussion, Mulford said that the US would probably make their announcement on 9-10 March. It was agreed that the Deputies would then meet in Amsterdam in the margins of the IADB meeting on 18 and 19 March to consider the US's proposals further and possibly to prepare a report for the G7 Ministers. It would be important for Deputies to give some preliminary

assessment at that meeting of the attraction to the banks of the proposals; obviously no consultations with them could be made until after the US announcement.

10. The meeting concluded at 22.45.

11. Discussion resumed the following day at 08.00 in Trichet's office in the Louvre.

12. Gyohten asked whether interest capitalisation could be included in the menu of options which would benefit from the US approach. Trichet observed that there was growing feeling in the European banks for interest rate capitalisation. Mulford opposed very strongly interest capitalisation on the grounds that it added to the stock of debt. Trichet retorted that some banks would not co-operate with the US proposal without the interest capitalisation option. Mulford repeated that that device was not compatible with the object of debt reduction. Trichet feared that without some such facility, some banks would offer no new money, demand continued full debt service and take legal action, for example by seizing aircraft, if debt service was interrupted. That could throw the US approach into great difficulty.

13. Mulford replied that Trichet's line of questioning ignored the reality of the situation now facing the banks. Debtors would shortly refuse to maintain debt service. Banks had to realise that. Things could not go on as before.

14. Trichet replied that the US approach could carry grave risks for the operations of the Paris Club. Under Paris Club philosophy, export credit agencies maintained their claims in full by rolling over principal and capitalising interest. Yet the commercial banks were being asked to accept reductions of principal and interest. This lack of symmetry would lead the banks to demand that the Paris Club should reduce debt and cut interest for the middle income debtors. It could only be remedied by permitting the banks to capitalise interest. Mulford replied that on no account would the US accept interest capitalisation. Trichet said that he would need to reflect deeply, in his capacity as Chairman of the Paris Club, on these consequences of the US proposals.

15. Mulford then asked whether G7 countries would put pressure on their banks to give the waiver. Tietmeyer and Wicks argued that these were matters of private contractual arrangement and Governments should not intervene. It would, however, be legitimate to say that the approach, if it were agreed, could only proceed if all the conditions were in place; and these would include a waiver negotiated between the country and its bankers.

16. The meeting concluded at 12.30.

CONFIDENTIAL

FROM: N L WICKS
DATE: 28 FEBRUARY 1989

CHANCELLOR OF THE EXCHEQUER

cc EST
Sir P Middleton
Sir T Burns
Mr Lankester
Mr Byatt
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Walsh
Mr Tarkowski
Mr Tyrie

Mr Cassell (Emb)

Mr Loehnis (B/E)

Thanks
That was 1st sight of the Mulford/Brady plan
Emerging / I like it.
The less the G7 and LDCs [illegible] clearly ~~keep to~~ [illegible]
(stick close together. N.

NEXT STEPS ON INTERNATIONAL DEBT

G7 Deputies met in Paris on Sunday evening and Monday morning to prepare for the Spring Meeting discussions on debt. Detailed records of the discussions are attached. Mulford asked for to be kept very secret. The main points are as follows.

2. Mulford said that the US had developed their proposal for a World Bank/IMF backed debt reduction schemes. In addition , they now have in mind a complicated scheme whereby the banks would reduce interest rates for strongly performing debtors - they have Mexico and Venezuela in mind - and the Bank and the Fund would give those reduced interest payments a limited guarantee. The US calculation of the effect of their proposals for Mexico is set out in their note attached.

3. Mulford emphasised that if the approach was to be presented successfully in the US, the Bank and the Fund should not require additional resources - no additionality. He conceded that the practical effect of the proposals would be to give greater help from Bank and Fund resources to the countries which qualified for the scheme; he was unclear which countries would lose, as would seem to follow if the no additionality constraint was maintained - and there were hints that in practice that constraint would not in the event be maintained.

4. My colleagues' initially welcomed the US approach - Trichet described it as "a historic moment". I said no more than that the proposals obviously needed study. Further reflection overnight introduced some doubts into my colleagues' minds: for example, how to deal with the problem of free rider banks who simply demanded continuation of debt service? what were the consequences for the Paris Club practice of neither reducing debt nor interest for the middle income debtors? should G7 Governments press their banks to give the waivers of the loan provisions required?

5. Mulford insisted that the US's announcement of their approach could not await the Spring Meetings. Secretary Brady would probably make a speech around 9-10 March. Mulford tried to obtain Deputies' agreement that the Secretary could say that other G7 countries were favourable to the US proposals. This produced general revolt. I said that the most that I could advise you to say was:

- you had been kept informed with the development of the US's thinking;

- you would study the proposals with interest;

- they would no doubt be considered at the Spring Meetings.

This is likely to be the general line. The US were clearly disappointed. They could well give the impression of greater G7 commitment to their proposals than is warranted.

6. During the discussion Mulford, emphasising that he was speaking on a personal basis, raised the possibility of a special issue of 7 billion SDRs. Every country would undertake to return the SDRs to the Fund so that they could be used for:

- guaranteeing further commercial bank interest streams (and so provide additionality);

- the clearance of Fund arrears.

Tietmeyer and myself made clear that we thought that our Ministers would wish to oppose this suggestion. I said that if it featured in Secretary Brady's announcement, you might well want to say that

!

you disagreed with it. Mulford replied that it was 99 per cent certain that it would not feature.

7. The Deputies are going to meet again at the weekend of 18-19 March, after the US announcement, to consider a report to G7 Ministers.

8. Before then we will provide you with a full assessmentof the new US approach. My preliminary reaction is as follows:

i. The US objective seems to be clear - rescue Mexico and other Latin American debtors who are putting up any semblance of good reform performance. Their schemes are ingenious. But they run a real risk of breaking well tried principles.

ii. Mulford's views on the SDR are a case in point. His conversion to an SDR issue is totally unprincipled. Indeed, the issue represents the worst form of creative accountancy - conjuring "free money" out of the air - and is in some respects worse than the conventional SDR proposal.

iii. The effect of the US approach is likely to be to tilt the operations of the Bank and Fund institutions in favour of the Latin American debtors. We will need to make sure that other deserving borrowers, eg India, do not suffer.

iv. One of the worst features of the scheme is that it encourages the impression that G7 are running after the middle income debtors - all hands to the pump to save Mexico! This will not in the long run encourage responsible economic policies.

v. One good feature of the scheme is that it need not lead to a further transfer of risk to the public sector. For this to be achieved G7 countries would need to ensure the tight management of the scheme, perhaps through the IMF.

vi. The scheme bristles with technical difficulties. These probably can be overcome, though at some cost to the sound principles on which the Fund and the Bank are run.

9. We cannot stop Secretary Brady making his announcement. There is, I think, a shade of doubt whether it will appear since Mulford was not clear whether the approach had full inter-agency and Presidential agreement in Washington. But my assessment is that some announcement will be made and some agreement entered into at the Spring Meetings. I should not be surprised if G7's support for the US proposals is somewhat more muted than the Deputies' first reactions. I suggest that our approach should be to ensure that the approach conforms, to the extent possible, with the underlying principles of the debt strategy and does not undermine the position of the Fund and the Bank. If the question of a special SDR issue arises, I hope that you will oppose it, and in public if necessary.

10. We will provide further advice.

N.L.W.

N L WICKS

chex.ps/jmt/43 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 1 March 1989

MR WICKS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Lankester
Mr Byatt
Mr H P Evans
Mr Mountfield
Mr Odling-Smee
Mr Bottrill
Mr Walsh
Mr Tarkowski
Mr Tyrie

Mr Cassell - (Emb)

Mr Loehnis (B/E)

NEXT STEPS ON INTERNATIONAL DEBT

The Chancellor was grateful for your note of 28 February.

2. He has commented that the more he sees of the emerg[illegible] Mulford/Brady plan, the less he likes it.

3. He has commented, further, that we and the Germans must clearly stick closely together.

J M G TAYLOR

typ3.sb 35/3 psf/sb.9.3.3.

FROM: HELEN WRIGHT
DATE: 2 March 1989

CHANCELLOR

cc Mr Sedgwick
Mr Mowl
Mr Ramsden

NET PUBLIC SECTOR DEBT

You asked for some further information on debt. Net general government debt can be taken back to 1972 only. However, figures on the National Debt are readily available back to 1855. A table showing national debt in £ billions and as a percent of GDP is attached.

2. You also asked for figures on general government debt for G7 excluding the UK. Table 2 shows net general government debt for G7 and for G7 excluding the UK.

Helen Wright
HELEN WRIGHT

Thanks. "Historical" picture was [illegible] stark with the FSBR with reference FWWI. But shows how, over past 10 yrs, our ratio of govt debt [illegible] has fallen continually whereas that of every other member of G7 has risen. Useable perhaps in Budget speech. ("Alone of the major nations ....") where it cd be compared with historical statistics ~~taken~~ from FSBR. [illegible]

AM/NB

typ3.to/35/3/psf/to.19.2.3

Table 1: National Debt

	£billion	per cent of GDP(1)
1855	0.8	105.0
1860	0.8	98.7
1865	0.8	81.4
1870	0.8	71.5
1875	0.8	59.0
1880	0.8	58.0
1885	0.7	57.2
1890	0.7	47.4
1895	0.7	42.6
1900	0.6	32.3
1905	0.8	36.7
1910	0.7	31.9
1911	0.7	29.6
1912	0.7	28.4
1913	0.7	26.3
1914	0.7	25.5
1915	1.1	35.3
1916	2.1	59.7
1917	4.0	88.4
1918	5.9	112.0
1919	7.4	133.1
1920	7.8	130.9
1921	7.6	147.5
1922	7.7	167.2
1923	7.7	176.6
1924	7.6	172.9
1925	7.6	163.6
1926	7.6	172.0
1927	7.6	163.8
1928	7.5	161.6
1929	7.5	158.7
1930	7.5	159.4
1931	7.4	170.1
1932	7.4	173.9
1933	7.6	179.5
1934	7.8	173.3
1935	7.8	165.2
1936	7.8	158.9
1937	7.8	147.4
1938	8.0	144.0
1939	8.2	138.0
1940	8.9	118.7
1941	11.4	129.1
1942	14.1	146.7
1943	16.9	165.1
1944	19.6	190.8
1945	22.4	227.8
1946	24.7	247.7
1947	25.6	240.6
1948	25.6	218.5
1949	25.2	203.2
1950	25.8	199.5

	£billion	per cent of GDP(1)
1951	25.9	179.8
1952	25.9	165.6
1953	26.1	154.7
1954	26.6	149.7
1955	26.9	141.0
1956	27.0	130.9
1957	27.0	123.6
1958	27.2	119.7
1959	27.4	113.8
1960	27.7	107.1
1961	28.3	103.0
1962	28.7	99.4
1963	29.8	98.7
1964	30.2	91.4
1965	30.4	85.0
1966	31.3	82.0
1967	32.0	79.4
1968	34.2	79.3
1969	34.0	72.8
1970	33.1	65.2
1971	33.4	59.3
1972	35.8	57.0
1973	37.2	51.5
1974	40.5	50.3
1975	46.4	46.5
1976	56.6	47.2
1977	66.9	47.6
1978	79.2	48.8
1979	86.9	46.1
1980	95.6	42.7
1981	113.3	45.6
1982	118.6	43.5
1983	128.2	43.3
1984	143.1	45.0
1985	158.3	45.7
1986	171.6	46.0
1987	185.7	45.9
1988	197.3	44.3

(1) GDP centred on 31 March for 1959 to 1988, and calender year GDP used prior to 1959.

(2) Sources
GDP:- 1946 to 1988 CSO series EBAA
GDP:- 1855 to 1945 Feinstein
National Debt and Net Public Sector Debt:- Bank of England Quarterly Bulletin

typ3.sb 35/3 psf/sb.9a.3.3.

TABLE 2: NET GENERAL GOVERNMENT DEBT AS A PERCENTAGE OF GDP

End Year	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987**	1988***
US+	25.7	22.9	22.1	24.5	24.2	23.1	21.2	19.6	19.7	19.3	22.3	24.9	25.8	27.8	29.9	30.3	30.0
JAPAN+	-6.5	-6.1	-5.4	-2.1	1.9	5.5	11.3	14.9	17.3	20.7	23.2	26.2	26.9	26.6	26.6	25.9	24.6
GERMANY+	-5.8	-6.7	-4.7	1.0	4.6	7.0	9.4	11.5	14.3	17.4	19.8	21.4	21.6	21.9	22.1	23.0	23.8
FRANCE	8.2	7.7	8.1	10.3	11.1	11.5	13.1	13.8	14.3	14.2	17.8	20.0	21.7	23.8	25.3	26.6	26.6
UK	63.9	57.0	54.5	57.0	56.3	55.3	53.0	48.1	47.5	46.7	45.9	46.3	47.6	46.6	45.9	43.4	39.1
ITALY	43.4	45.2	42.7	52.0	52.8	52.7	55.4	55.3	53.6	57.3	63.4	68.7	74.2	80.9	85.6	89.1	92.0
CANADA	4.2	2.6	1.1	4.3	5.2	7.6	10.4	11.0	11.8	10.8	17.2	20.6	25.1	30.6	34.4	36.2	36.7
G7	18.8	16.9	16.5	19.8	20.8	21.2	21.7	21.5	22.1	22.9	25.9	28.5	29.8	31.5	33.1	33.5	33.1
G7 EXC UK	15.2	13.8	13.5	16.9	18.0	18.4	19.2	19.3	20.1	21.0	24.2	27.0	28.3	30.2	32.0	32.6	32.5

+ as percentage of GNP
* OECD standardised figures. Equal to total liabilities minus total financial assets (excluding corporate shares and reserves but including tax on income earned during the year whether or not collected)

** OECD estimates

***OECD forecasts

FROM: N L WICKS
DATE: 2 MARCH 1989

MR H P EVANS

cc PS/Chancellor
PS/EST
Sir P Middleton
Mr Lankester
Mr Mountfield
Mr Walsh
Mr Bottrill
Mr Crockett - B/E

(Mr Lankester shd ... a note on 24/3)

EUROPEAN COMMUNITY AND INTERNATIONAL DEBT

There was some discussion in the margins of the Monetary Committee yesterday about the Spanish Presidency's suggestion that ECOFIN should have a discussion of international debt.

2. Apparently, the Spaniards are determined to have such a discussion - partly I presume because of their traditional interest in Latin America. Neither the Germans (particularly) nor the French and Italians evinced much enthusiasm for the prospects of an ECOFIN discussion. But no-one believes that the Presidency could now be dissuaded. I said that there was a risk that too much attention was being paid in the international fora to Latin American debt. This simply created unreasonable expectations and diverted the debtor countries from the crucial task of economic reform. As regards the ECOFIN discussion, I said that the Community had little locus in international debt matters, except in the field of trade and agriculture. I thought that the Chancellor might want to take the opportunity of the ECOFIN discussion to remind the Council of the deleterious effects on the developing world of aspects of the CAP and EC trade policy.

3. The Commission are drafting a paper, or rather a non-paper. It will cover trade and agricultural aspects. So as to keep COREPER and the diplomats out of the discussion, the paper will be sent by Minister Solchaga to the members of ECOFIN under the cover of a personal note.

4. Finally, recipients of this minute should also be aware that Beregovoy has invited Governors of the Inter-American Development Bank to a day's seminar in Paris on 23 March on Latin American and the Caribbean with the theme "libertés et Economie".

5. The UK Governor is Mr Patten, whom I understand has another engagement. I believe that it is suggested that Mr Eggar should go in his place. My guess is that the seminar will be a non-event. Many senior Community Ministers seem to be unavailable. Trichet did not seem bothered.

N.L.W.

N L WICKS

chex.rm/aa1/55

UNCLASSIFIED

FROM: A C S ALLAN
DATE: 3 March 1989

1 Mowl
2 Pug

MS H WRIGHT

cc Mr Sedgwick
Mr Mowl
Mr Ramsden

~~EB~~ ~~BE~~ 16

NET PUBLIC SECTOR DEBT

The Chancellor was grateful for your minute of 2 March. He feels the "historical" picture is now adequately dealt with in the FSBR with the reference to World War 1. But he thought it was striking how, over the past ten years, our ratio of Government debt to GDP has fallen considerably whereas that of any other member of the G7 has risen. He is considering making this point in his Budget speech.

ACSA

A C S ALLAN

ec.jn/Symes/wicksdebt

AP P.

FROM: SUSIE SYMES
DATE: 6 MARCH 1989

MR WICKS

cc: PS/Chancellor
PS/EST
Sir Peter Middleton
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Bottrill
Mr Walsh

EC AND INTERNATIONAL DEBT

I have just seen your minute of 2 March reporting the Monetary Committee discussion of a possible ECOFIN discussion of international debt.

2. Debt will be discussed at ECOFIN on 13 March in a Ministers only session, probably over lunch, but - in part because of UK manoeuvring - will not appear on the formal agenda and is being taken under the general heading of preparations for the Spring meeting.

3. A paper is being produced for the 13 March ECOFIN (by Mr Dixon, to whom Mr Lankester has spoken). Despite what the Spanish Presidency said at Monetary Committee, it may emerge as either a Presidency non-paper or a Commission non-paper.

4. I think Spanish determination goes beyond an ECOFIN discussion: it seems as if they want to run their own initiative at the Madrid Council in June, aiming for discussion at the July Summit in Paris. (You may like to glance at the attached Spanish newspaper article from January). And Commissioner Marin - Spanish Commissioner responsible for Development - is known to have ambitions.

As usual: what do we know about this?

Susie Symes
SUSIE SYMES

El País

Jueves 26 de enero de 1989

9

España ajusta un plan para la deuda exterior de los países en desarrollo

LA/ econ

CARLOS SCHVARTZ, Barbados
ENVIADO ESPECIAL

España ha alcanzado un principio de acuerdo con Francia y Alemania Occidental para proponer a través de la Comunidad Europea (CE) un nuevo plan para la deuda exterior de los países en desarrollo, declararon en Barbados altos funcionarios españoles.

La propuesta debería tomar forma definitiva en la *cumbre* de la CE, que se celebrará en Madrid el 29 de junio, con la que se cerrará la actual presidencia española en la Europa de los *doce*. La iniciativa debería adquirir consistencia internacional en la *cumbre* que los siete países más industrializados celebrarán en París, en julio próximo, en la cual EE UU y Japón deberán tomar algún compromiso para la sustitución del fenecido Plan Baker.

En esencia, el proyecto consiste en la condonación de entre el 25% y el 30% de la deuda exterior viva. La sustitución de parte sustancial de la deuda restante por emisiones de bonos, que permitieran la recompra de los mismos en los mercados internacionales de deuda, con un descuento variable, relacionado con el nivel de riesgo del país. La recompra permitiría a los tenedores de los bonos capitalizarlos. La capitalización consiste en la cancelación de los bonos contra la entrega por parte del deudor de activos a cambio de ellos. Estos activos pueden constituir un volumen de negocio para los acreedores. Es el caso, aún pendiente, de la entrada de la Compañía Telefónica Nacional de España en la Entel argentina.

González, puso al tanto de este objetivo al presidente electo de Venezuela, Carlos Andrés Pérez, el pasado viernes, durante una cena en la Moncloa. Pérez pasó por Madrid y París en una visita relámpago. El contacto en Francia tenía esencialmente el mismo objetivo. González y François Mitterrand acordaron una acción conjunta sobre la deuda exterior en la última reunión de ambos en Montpellier.

Durante la cena en Madrid, a la que también asistió el ministro de Asuntos Exteriores, Francisco Fernández Ordóñez, Pérez manifestó su acuerdo con el plan español. Este hecho ha convertido al 2 de febrero próximo, fecha de la asunción del mando del presidente venezolano, en la oportunidad de mantener contactos multilaterales con este fin.

Pérez había ya sondeado a los presidentes de México, Carlos Salinas, y de Brasil, José Sarney, sobre la posibilidad de una acción común. La maratón de Pérez tenía además por objetivo asegurar la presencia en Caracas de los siete mandatarios clave en materia de deuda externa para ajustar detalles.

El Gobierno español está esencialmente preocupado por la tensión política en la región tras filtraciones de alto nivel sobre coordinación de sectores golpistas de cuatro ejércitos latinoamericanos. Los funcionarios consultados no desmintieron de que las gestiones hayan estado a cargo de oficiales argentinos, brasileños, peruanos y bolivianos.

ROUGH TRANSLATION OF ARTICLE FROM EL PAIS OF 26 JANUARY 1989

SPAIN PROPOSES A PLAN FOR THE EXTERNAL DEBT OF THE DEVELOPING COUNTRIES

High level Spanish officials announced in Barcelona that Spain has reached agreement in principle with France and FRG to propose a new plan for external debt of the developing countries. This plan is to be proposed via the EEC.

The proposal would take concrete form at the EEC summit in Madrid on 29 June, the last meeting at which the Spanish will preside over the twelve. The summit of the seven most industrialised countries in Paris next July should give the agreement international coherence, as the US and the Japanese will have to make compromises in their search for substitutes for the defunct Baker Plan.

In essence, the plan consists of writing off 25 to 30 percent of the "live" external debt. The remainder would be substituted to a large extent by bond issues which would allow their buyback in international debt markets at a variable discount. This discount would be related to the level of risk of each country. The buyback would allow bond holders to capitalise them, this capitalisation consisting of cancelling the bonds against surrender by the debtor of equities. This equity could form a volume of business for the creditor. The entry of the Spanish National Telephone Company (Compania Telefonica Nacional de Espana) into the Argentine company ENTEL is an example (although as yet not definite).

PROGRESS

Felipe Gonzalez put such a scheme to the President-elect of Venezuela, Carlos Andres Perez during a state dinner. Perez was passing through Madrid and Paris on a whirlwind tour. Contact with France had basically the same objective. Gonzalez and Mitterrand agreed upon a joint action on external debt at their last meeting in Montpelier.

SS3ADP

During the Madrid dinner, which the Minister for Foreign Affairs, Francisco Fernando Ordonez, attended, Perez demonstrated his agreement with the Spanish plan. The approaching 2 February, date of the Venezuelan President's inauguration, will now be a very different affair, turned into an opportunity for Perez to maintain multilateral contacts with this plan in mind.

Perez has already sounded out the Brazilian, Sarney and the Mexican, Salinas about the possibility of a common stance. Perez's marathon also included the intention to secure the participation of the 7 key creditor countries at the inauguration in Caracas.

The GOS is worred about political tension in the area, made known by leaks from high levels about potential pockets of unrest within the militias of four Latin American armies. It has not been denied that these countries are Argentina, Brasil, Peru and Bolivia.

SS3ADP

chex.ps/jmt/55 RESTRICTED

FROM: J M G TAYLOR
DATE: 6 March 1989

MR WICKS

cc PS/Economic Secretary
Sir P Middleton
Mr Lankester
Mr H P Evans
Mr Mountfield
Mr Bottrill
Mr Walsh
Ms Symes

EC AND INTERNATIONAL DEBT

The Chancellor has seen Ms Symes' note of 6 March.

2. He has commented that the Spanish intention to run their own debt initiative at the Madrid Council in June, aiming for discussion at the July Summit in Paris, is astonishing. He wonders what else we know about this.

J M G TAYLOR

INTERNATIONAL DEBT

covering CONFIDENTIAL

FROM: H G WALSH
DATE: 8 March 1989

CHANCELLOR

cc: Economic Secretary
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr Evans
Mr Peretz
Mr Gieve
Miss O'Mara
Mr Melliss
Mr Kilpatrick
Mr Tarkowski
Mr Segal

MEETING WITH ALAN GREENSPAN

I attach a brief on international debt for your meeting with Alan Greenspan tomorrow. It takes into account the latest developments on the Mulford/Brady debt plan.

2. Given that the Brady speech is to be made on Friday, we should be grateful for your approval of the proposed public line (to be taken with the press, etc) in paragraph 3 of the brief.

H.W.

H G WALSH

INTERNATIONAL DEBT

Latest Developments

1. We have been told by Mulford that Secretary Brady will be announcing the US debt reduction plan on Friday in a presentation to the Bretton Woods Committee of Congress. We do not know the content of the speech, but we imagine that it will take the form of a generalisation of the proposals made by Mulford discussed in Mr Wicks' minute of 28 February. We assume Greenspan knows about the speech. A copy of the proposals as put to G7 Deputies is attached.

behind

Objectives

2. Our main objective for the discussion with Greenspan is to indicate to him what our public response to the Brady speech will be and - given that the Fed itself may have reservations about the scheme - the main areas where we have doubts.

LINE TO TAKE

UK Public Line

3. We propose to take the following line in reacting to the US proposals when they are announced:

i. Existing debt strategy has made a valuable contribution to dealing with debt problems. The strategy has evolved and will continue to do so.

ii. The proposals are an interesting extension of the existing strategy which already includes the explicit option of voluntary debt reduction.

iii. The proposals will need very careful study in the run-up to the Interim Committee meeting on 3 April when we expect them to be further discussed.

(If asked about any disadvantages or whether they constitute a change in the present strategy - eg whether they bail out the banks - our response would be that this is precisely the kind of question which we shall be examining in the run up to the meeting of the Interim Committee).

For Use with Greenspan Only:-

iv. We shall be examining the proposals with respect to three main criteria:

(a) Whether they are consistent with obtaining more adequate economic reforms in the countries concerned.

(b) Whether the scale of debt conversions is feasible at the prices suggested, and will achieve enough debt service reduction, and whether the burden sharing between the public sector and the private sector is acceptable.

(c) The extent to which the application of the proposals would give rise to any undesirable breach of the principles under which the IMF and the World Bank operate. (For instance, it is proposed that the IMF, as distinct from the World Bank, should use some of its resources to backing guarantees and that the World Bank should use some of its resources for providing large scale guarantees for debt reduction. These are very radical proposals).

v. Our initial reaction is to oppose the use of Fund or World Bank guarantees, and prefer buybacks for a number of reasons:

(a) over a range of reasonable assumptions buybacks are at least as effective a use of IFI resources as guarantees;

(b) finance for buybacks avoids the hazard that guarantees create by intermingling of IFI and bank claims;

(c) buybacks represent a much more market-related approach than guarantees, and so offer the prospect of an earlier return for the debtors to normal market access.

(d) World Bank interest guarantees for commercial bank debt may create a new preferred class of debt service, which could be to the detriment of repayments on non-preferred public sector debt service, eg Paris Club.

(e) Large scale use of guarantees would set a bad precedent, whereas normal policy-based lending by the World Bank can be used to reconstitute reserves of debtors after buybacks.

BACKGROUND

Likely Views of the Fed on the Brady/Mulford Proposals

4. Greenspan's concerns are likely to be about (i) the intrinsic merits of the scheme and whether it will mark the end of new money packages and (ii) narrower regulatory aspects.

5. On 4(i), we believe the Fed views are likely to be :-

i. The arithmetic of the Mulford scheme does not add up (unless there is a massive increase in IFI lending/guarantees -involving a transfer of risk - or reallocation in favour of Mexico. The amount of debt service relief achieved seems to be over-estimated by Mulford).

ii. The programme risks encouraging the Fund to lend to countries in arrears with the banks.

iii. The proposals could mean the destruction of the advisory committees and lead to pressure being put on the banks by governments.

iv. Using IFI money through buybacks might achieve more debt reduction than using it for guarantees as Mulford (partially) proposes.

6. We share most of these doubts, especially those at 5(i) above, and 5(ii) and 5(iii) are possibilities.

7. On 5(iv), we are doing further work on the question of whether buybacks are more cost effective than guarantees in debt reduction schemes. We think so. But it is unlikely that there can be any absolutely firm conclusion on this. The issue may turn on differences in perception about the probabilities of repayment between the IFI granting the guarantee and the bank receiving the guarantee. It also depends on whether, if part only of payments on principal and interest on a commercial bank loan are guaranteed, any implicit seniority will nonetheless be accorded by the debtor to repayments of the non-guaranteed element of the principal and interest. If so, in a zero-sum game, other public sector and/or banks debt would receive less seniority. The distribution of dilution of seniority is impossible to predict both on explicit and implicit credit enhancement of specific loans by the World Bank. Paris Club debt seems likely to suffer. In any event, the World Bank does not want to get involved in the large-scale issue of guarantees for debt reduction and we do not want them too either. We certainly do not want the IMF, as an institution with revolving resources, to get involved.

<u>Regulatory Issues</u>

8. On 4(ii) current issues include possible changes in the US rules on:-

i. Rules relating to tax relief on writedowns/ provisioning.

ii. Interest capitalisation as a way of providing new money.

iii. Compulsory provisioning when bank assets become non-performing.

9. G7D are collecting material on regulatory and tax aspects of debt reduction in each of the seven countries, on which we shall report as necessary at a later stage.

chex.md/jmt/8 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 9 March 1989

MR WALSH

cc PS/Economic Secretary
Sir T Burns
Mr Wicks
Mr Lankester
Mr Scholar
Mr Evans
Mr Peretz
Mr Gieve
Miss O'Mara
Mr Melliss
Mr Kilpatrick
Mr Tarkowski
Mr Segal

INTERNATIONAL DEBT: LINE TO TAKE ON US DEBT REDUCTION PLAN

The Chancellor has seen your briefing note of 8 March for his meeting with Mr Greenspan. He is content with the line to take in public on the US proposals when they are announced.

J M G TAYLOR

UK

SECRETARIAT GENERAL
DU CONSEIL

COORDINATION GENERALE

le 9 mars 1989

Action: Ms Symes
cc: PMG
EST
Mr Wicks
Mr Lankester
Mr Rib Allen
Mr HP Evans
Mrs ME Brown
Mr Walsh
Mr McMigs

TELECOPIE

DESTINATION : M. Nigel LAWSON
Chancelier de l'Echiquier

POUR : CONSEIL ECOFIN DU 13.3.89

DE LA PART DE : M. N. ERSBØLL, Secrétaire général

NOMBRE DE PAGES : 2

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UK + IRL + I

7 March 1989

CONFIDENTIAL

GROWTH, TRADE AND DEBT IN MIDDLE-INCOME DEVELOPING COUNTRIES

(Non-paper for the ECOFIN Meeting, 13 March 1989)

7 March 1989

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During the decade of the 1980s, the worsening economic condition of a number of developing countries has become more preoccupying. Their situation has contrasted sharply with the improved outlook in the industrial countries.

Since a two track world economy is unacceptable and inefficient, the question of how to induce appropriate economic management and performance in the LDCs requires examination. This informal note outlines the main issues and some of the options for joint action by the Community and its Member states, especially in the areas of trade, finance, and the role of multilateral institutions.

1. The Causes of Uneven Economic Performance

While, in this long recovery, OECD countries' economic growth has been satisfactory, supported by strong trade and accompanied by declining inflation, developing countries have shown an uneven capacity to adapt to, and benefit from, this new environment.

The performance of fast-growing Asian NIEs, China and India, has contrasted with deteriorating prospects in Latin America, Sub-Saharan Africa, Middle East and the Mediterranean region:

Table 1: Growth and Inflation

	Real GDP Growth	Inflation*
	(Average % change	1981-1988)
Asian NIEs	8.6	3
China and India	8.1	6
Latin America	1.5	120
Sub-Saharan Africa	0.7	23
Middle East	-3.3	7
Mediterranean region	2.6	44

* Estimated weighted average of consumer prices

Among the causes of these divergent trends are a different vulnerability to high real rates of interest and falling commodity prices, a different capacity to exploit export opportunities in manufactures. Policy differences have also played a role. A further element in many cases has been the accumulation of external debt.

Slow growth and poor creditworthiness interact perversely: the diversion of resources from import and investment to external debt servicing hinders the improvement of export, output and adjustment.

Short-term expedients have often rendered the debtors' problems even more intractable. Worsening education, health and nutrition standards have affected domestic human resources. Deforestation and desertification have started to affect the global economy as well, giving rise to important environmental threats.

This paper's working hypothesis is that the poor prospects for indebted countries have significant implications for industrial countries. Their economic stagnation reduces export markets for the rest of the world, while increasing political and social risks.

2. Framework for analysis

Experience with debt initiatives for low-income countries in the Venice and Toronto Summits shows that concerted action by the Member States and the Commission gives the Community as a whole a considerable influence on decisions.

A common approach through multilateral actions and multilateral institutions could go a long way in the search for solutions to break the vicious circle of low growth and over-indebtedness in middle-income countries. Three interrelated issues should be considered.

Trade

Throughout history, trade has been both a means of development and a measure of success. The over-indebted middle income countries have been forced to compress imports in order to generate current account surpluses in the wake of sharply declining external finance. Their exports, especially in manufactures, have not kept pace with world trade.

The EC is an increasingly important trading partner of the LDCs.

Table 2: Trade with 15 highly indebted countries
(in $ billions)

	Exports + Imports		Balance of trade	
	1981	1987	1981	1987
EC	60.5	64.4	+2.9	-8.5
USA	80.9	80.4	-0.5	-17.6
Japan	19.4	14.1	+3.2	-0.3
Other OECD	23.2	14.1	-1.4	+0.9

A greater integration of developing countries into the multilateral trade system and the discipline attached to the opening up of these countries would improve their development performance. On the part of OECD countries, further openness would be instrumental in enhancing the consistency between global objectives and trade policies.

Recent policy developments in the Community have been in this direction, including the reforms of the CAP. The Community is firmly committed to making a success of the Uruguay Round, in which tropical products have already been singled out for specific action. Moreover, structural adjustment should continue in the industrial countries so as to progressively eliminate non-tariff barriers in industrial products. In this respect 1992 will make an important contribution.

To enhance competitiveness, developing countries' economic reforms should also lead to increased openness through more active partipation in the GATT. Important steps in this direction on their part could include the agreement on a timetable for tariff reduction and the integration of these reforms as far as possible in the GATT process. Measures should also be taken to encourage further foreign investment.

Negotiations aiming at this parallel liberalisation should take place in a multilateral framework. Developing countries still play only a minor role in the Uruguay Round, largely because of their attachment to special and differential treatment accorded in Part IV of the GATT. This treatment however has been partly eroded due to the reduction in tariff barriers, the increase in non-tariff barriers and the multiplication of bilateral agreements. A clear commitment by both industrial and developing countries to multilateralism could lead to a renewed vigour and adherence to the original principles of the GATT.

Finance

A recent World Bank survey on the investment/GNP ratio for 90 LDCs, found that the historical average of 25% was associated with a growth rate of output of about 4%. Higher performers (the NIEs of Asia) have had investment shares of 30-40%. In Latin America the share fell to 15% in 1987-88, from 25-28% in the 1970s. There is a lesson to be learned from this. Better economic management in the less successful LDCs will allow them to exploit more fully their own resources, including a reversal of capital flight; and to generate a greater inflow of non debt-creating foreign capital. However, appropriate economic management, while necessary, may not be sufficient. In many cases the weight of past debts may prevent the implementation of successful domestic policies.

In turn, the organisation of adequate external financing to help highly indebted countries' structural reforms and new development priorities has its own limit: the limit being the extent to which external public sector creditors are willing to lend in the face of the commercial banks' withdrawal from providing finance to debtors.

How to close the gap between (i) the limited capacity to service debts solely through indigenous efforts and (ii) the limited availability of financing from external public sector sources? This gap can be closed in various ways.

I. A greater role for commercial banks is essential. (a) Commercial banks could be offered rules of equivalence among the various options available to support the indebted countries. The absence of such rules has impeded the development of a fuller menu of options, just as the efforts of official creditors and donors to assist low-income countries were also hampered before the recent Paris Club consensus. (b) The tax and prudential treatment of banks' loss provisions in respect of their claims on developing countries is relatively varied and induces differences in assessment and distortions in competition among banks. Greater comparability of efforts by banks in different countries as a way to encourage their burden sharing could be achieved through concerted supervisory and fiscal changes.

II. In 1985-1988 about $30 bn voluntary debt-reduction transactions took place, half of them in 1988 alone. Voluntary debt reduction based on market-oriented financial techniques could help develop a secondary market for banks' claims. That could be expedited by international concerted regulatory and supervisory measures to enhance provisions for loan-loss reserves and for a strengthening of banks' capital bases. It could also be strengthened by the creation of an international facility that would, subject to the appropriate conditions, assist the process of debt reduction either through some form of guarantee or by transferring the ownership of some of the debt.

iii. Increased flows of official development assistance should foster adjustment, in particular through quick-disbursing finance and long-term economic development assistance, taking into account human resources, social aspects and environmental protection.

Multilateral institutions

Multilateral institutions have played, and will play, a central role in the debt strategy. This role has evolved. The IMF and the World Bank have been given new tasks which to some extent overlap: adjustment and monitoring over a longer period for the IMF, sectoral and structural adjustment for the World Bank. They have increased responsibilities with regard to the conception and implementation of structural reforms in countries over-indebted to banks. As structural adjustment is closely linked to trade reform, there is an increasing need for them to work more closely with the GATT.

Table 3: Net flows to highly indebted countries
($ billions average pa)

	1982-85	1986-88
IMF	3.4	-0.5
World Bank	2.4	2.6
IDB	2.5	1.4
Total	8.3	3.5

Each institution should be strengthened and their respective roles should be clarified. An agreement between EC Member States on this broad issue would be of great help, in parallel with the ongoing deliberations in the G10 context.

The Community is playing an increasing role in the structural adjustment process in Sub-Saharan Africa. The role will be further strengthened in the next ACP-EC convention. Effective action supposes however improved coordination within the Community as well as between the Community, its member states and the Bretton Woods institutions, concerning adjustment support in ACP and other developing countries.

3. Main issues for discussion

The poor prospects for the developing countries, particularly the over-indebted countries, have significant implications for the industrial countries. Ministers may wish to discuss this topic around the following three main issues:

- If a broad approach embodying both trade and finance measures is desirable, how best can these two domains of policy be made to support each other? How can a multilateral approach fully support the need for reform and adjustment in specific over-indebted countries?

- In order to limit the transfer of risk from private to public creditors, a better sharing of efforts and responsibilities is needed. What measures are necessary to ensure a satisfactory burden sharing?

- The role of the multilateral institutions is a key one. What should be done to strengthen their role and to promote a better cooperation between them? Would for example an increase in IMF quotas and a new allocation of SDRs be necessary to indicate the industrial countries' determination to support the adjustment efforts and requirements of the highly indebted countries within the framework of programmes designed by the multilateral institutions? How should the lending programme of the World Bank and IDB develop?

SECRETARIAT GENERAL
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le 9 mars 1989

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