APPENDIX

THE MAJOR DEBT PROPOSALS
This chapter provides summaries of the most representative debt proposals. The Baker Initiative, one of the best known and most discussed debt plans, is not reviewed here, nor are proposals for debt relief to low income Sub-Saharan countries. For proposals with multiple features the most salient aspect (e.g., debt forgiveness in plans that combine concessions with new lending) is used for ranking.

**Increased lending by official and commercial sources**

Most new money proposals share the concerns of the Baker Initiative but set higher targets for new lending and, in some cases, recommended the creation of a new international agency as coordinator of conditionality. Their usual weakness is the absence of safeguards against free riding, as participation is deemed voluntary.

**The de Carmoy Proposal (1987)**

This recent proposal envisages that the Governments of the U.S.A., Japan and European countries would assume joint responsibility for increased lending to the original Baker 15 plus Poland and Romania. The plan would be implemented in stages: during an initial trial phase only three countries — two Latin American and one other HIC—would be used to test the plan's effectiveness.

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After it is extended to the seventeen target countries, this plan would aim to raise new lending by at least $30 billion per year, for ten years. Of that total, the multilateral banks would provide $5-8 billion per year for project loans, and industrial countries $15 billion at concessional rates. Commercial banks would provide the balance for project or trade financing. During each of the first three years of full operation, $3 billion would be set aside in a Compensatory financing Facility to protect debtors against unforeseen increases in real interest rates.

de Carmoy's three explicit aims are to: raise real GNP growth in the target countries to 6 to 7 percent; provide sufficient time for structural adjustment; generate "credibility" for the plan in the largest HICs. It stressed the need for a case-by-case approach.

A central feature of de Carmoy's proposal is the creation of an Action Committee comprised of representatives of the private and public sectors of the sponsor governments. The Committee would administer total lending, coordinate the commercial banks's share of total lending and coordinate agreement on the required conditionality between lenders and borrowers. The Committee's staff would be limited, as it would draw extensively on the World Bank's and IMF's design of conditionality and adjustment programs. Finally, the committee would "self destruct" after the ten-year implementation period of the increased lending is concluded.
Superseding its coordinating role, the Committee's main purpose would be to add "political momentum and weight to the process." In other words, it would create moral suasion for the banks to increase lending, and for the debtors to adhere to the conditionality. Beyond that organisational aspect, the de Carmoy proposal is essentially an expanded version of the Baker Initiative.

The plan's self-avowed weaknesses are its cost to industrial countries (an estimated 0.3 percent of the combined GNP of the USA, Japan and the EC in each of the plan's ten years, to cover their share of total lending), and the lack of political consensus. To this one could add the cumbersome structure of the Action Committee, the lack of sanctions against free riding, and focus on a single remedy: more debt.

**Japan's recycling plan**

In 1987 the Japanese government pledged to recycle up to $30 billion equivalent of its current-account surplus in favor of developing countries in two trances of respectively $10 and $20 million equivalent, the latter of which will be spread over three years, ending in 1990. This amount includes both public and private funds that will be deployed in the form of (i) supplementary budgetary allocations for credits to the IMF and IDA; (ii) the establishment of the Asian

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(2) Ibid.

Development Fund, to be administered by the Asian Development Bank; (iii) loans by Japanese commercial banks to the Multilateral Development Banks including the World Bank, (iv) expansion of united cofinancing with international development institutions by the country's Overseas Economic Cooperation Fund, the Export-Import Bank of Japan (EXIM) and Japanese commercial banks; and (v) expansion of direct loans to developing countries through united EXIM loans.

The Japanese initiative included the creation of a Japan Special Fund in the World Bank. This fund is comprised of grants of Yen 30 billion for "united" cofinancing by Japanese commercial banks of World Bank Projects and programs. It is also provides for expanded access for World Bank borrowings in the Japanese capital market, in an amount of Yen 300 billion (a total of over $2 billion), to be spread over three years.

As part of that recycling, Japan also intends to accelerate by two years its plan to double its official development assistance (ODA) to developing countries and to have ODA disbursements of more than $7.6 billion in 1990. In 1986, the Japan's ODA already rose to $5.6 billion, so that it has replaced France as the second largest provider of ODA, after the United States. Japan has traditionally extended much of its aid to developing countries in Asia, but in recent years, it has increased its grants to Sub-Saharan African countries.

This plan is already operating: Yen 6 billion that are part of the first tranche were deposited with the World
Bank in 1987. The main criterion of success will be that the recycled funds are used for productive means by the recipient countries. Recipient governments and financing agencies will therefore need to ensure effective evaluation and monitoring of projects and programs financed by these funds. However, the plan's size should not be overestimated, as it includes funds that would have been allocated in any event (for example Japan's contribution to IDA-8). In addition, a large part of the "recycling" will involve private funds, including commercial cofinancing and enlarged access for World Bank borrowings in the Tokyo Market.

New commercial lending supported by credit enhancement

The Lever plan (1983)\(^{(4)}\)

The original formulation of this plan by Lord Lever and Christopher Huhne dates back to 1983 and has been revised since then. Its central feature is partial risk coverage, comparable to that offered by the export guarantee schemes of industrial countries. The beneficiaries (creditors) would have to pay variable premia that reflect the underlying risk, and part of the risk would remain uncovered. The main difference from existing practices is that coverage would be subject to periodic ceilings, to be set by the IMF on a case-by-case basis in light of each debtor's projected negative cash flow. New loans covered under that ceiling would be subject to strict conditionality.

\(^{(4)}\) Harold Lever & Christopher Huhne, op. cit., Chapter 9.
agreed between the IMF and the borrower, aimed at stimulating growth and investment. The policies to be adopted as part of the conditionality, while necessarily "sound, even austere"(5), would stress positive net transfers. They would also aim to relieve the foreign-exchange constraint on the debtors' growth.

The ceiling for new lending—originally estimated by the authors in a range of $30 to 40 billion—could be adjusted in light of international developments: it could be increased after a new external shock to allow greater time for adjustment in debtor countries, or be reduced in periods of rising inflation. The guarantees would also aim to achieve the finest market rates for new loans and would be administered by national export credit agencies within guidelines and ceilings set by the IMF. Consistent with the practice of export credit guarantees, the new loans would be provided by commercial banks, but the ultimate liability for defaults on guaranteed loans would fall upon the industrial countries, through the IMF.

Obviously, the borrowers could only benefit from this scheme if the guarantee premia are lower than the cost savings on risk-adjusted lending rates. But this plan offers the benefit of simplicity—there would be no new institution. It would also offer safeguards against free riding by forcing nonparticipants to write down non-performing loans and, through partial guarantee coverage, ensure burden sharing between official guarantors and private banks. However, it shares the

(5) Ibid. p. 141.
weakness of the de Carmoy proposal by advocating increased lending, even to countries with severe debt overhangs. This may well reflect the plan's age: in 1983 the consensus was that HICs suffered from illiquidity that could be resolved by increased lending flows.

The Rotberg Plan (1983)\(^6\)

This plan emanates from the World Bank's former treasurer. Like Lever, Rotberg recommends partial guarantees. In this case only the principal amount of loans would be covered, so that commercial creditors would not need to write down their book value in the case of default. Coverage would be provided by means of complex financial engineering techniques.

Under the Rotberg plan, new commercial lending would be long-term, with maturities of up to 20 years. Those loans would run in parallel with World Bank structural adjustment loans (SALs), and have substantial balloons at the final maturity. The World Bank would guarantee the principal amount of those loans by offering a "put"--that is, a commitment to purchase. The put would be at par, cover all principal repayments, and only be exercizable after 20 years. (This explains the proposed maturities for new loans, and the need for balloon repayments.)

Lenders who exercise for put--i.e., who use the Bank's guarantee--would automatically be obliged to relend the

\(^{6}\) The Economist, 5/14/1988, p 83.
same amount to a new World Bank affiliate for another 20 years. Those new loans would be at variable rates corresponding to the yield of 3-month US Treasury bills. The Bank's affiliate would use the proceeds of that loan to purchase the original credits.

Rotberg's approach offers the advantage of burden sharing: in return for improved protection, the lenders too would have to be prepared to make certain sacrifices; an original commitment of up to 20, plus the obligation to onlend for a further 20 years if the guarantee is exercised; low yields during the latter 20 years. A further advantage is that, except for the capitalization of the World Bank's new affiliate, the plan would be largely self-financing: the affiliate's repurchase of risk assets would be financed by the original lenders, at the finest available market rates.

However, Rotberg's plan also has certain weaknesses. It is organizationally complex, notably in requiring the creation of a new World Bank affiliate. It involves complex financial engineering. Only new lending in US dollars would be eligible for the Bank's puts, which would exclude non-US creditors that elect to lend in their own currencies. The dollar emphasis may also be sub-optimal if it increases the dollar exposure of countries whose export earnings have a large non-dollar component. Finally, there are no "sticks" to deter free riders.
Among other credit enhancement proposals is that of First Interstate Bank\(^7\). This plan incorporates some of the features of Mexico's securitized debt defeasance scheme of 1987: a condition of new loans by commercial banks would be that part of the loan proceeds be set aside by the borrowers to purchase US Government zero-coupon bonds that would serve as collateral.

**Interest stabilization**

The principles and techniques of interest-rate stabilization were set out in the previous section. One variant to protect debtor countries against future increases of the nominal cost of debt is to use the principles applied in adjustable-rate mortgages, so that a ratchet would limit interest-rate increments from one interest payment date to another. This is based on the assumption that most debtors can accommodate small variations in nominal—and real—costs, but are destabilized by extreme fluctuations of interest rates, such as those that occurred at the start of this decade.

Implementation of that type of protection would require an institutional framework, for instance an Interest Stabilization Facility (IFS), sponsored and funded by industrial countries. The IFS that would bear similarities with Interest Compensation Facility of the now defunct Herrhausen proposal\(^8\)

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(8) World Debt Tables 87-88, Box 5.
and with de Carmoy's Compensatory Financing Facility.

Its role would be to determine the appropriate ceiling for a "moving interest-rate cap" in any given period. Maximum increments would be defined in light of anticipated interest-rate trends, and of the capacity by eligible debtors to absorb certain rate increments. The ISF would also be a central clearing house between lenders and debtors. Whenever market rates exceed the cap, the ISF would pay that excess to commercial creditors on the debtors' behalf, and capitalize it as a direct claim on the debtors. To amortize that claim, debtors would continue to pay the ISF the capped rate when interest due on the original floating-rate loan falls below the cap. Depending on whether any residual claim outstanding is extinguished at the maturity of the cap, debt stabilization of this kind could involve a concessional element, akin to interest-rate relief.

The ISF's commitments could be underwritten by a pool of central banks. In practice those commitments and risk exposure are likely to be limited, even if interest rates rise over long periods of time. Extreme turbulence of interest rates, rather than steady increases, occurs seldom. Moreover, the ISF could set caps at levels that minimize its exposure. The main drawback of this approach is its operational and institutional complexity.

Debt Relief through interest-rate reductions

Interest forgiveness is legally distinct from risk transformation through swaps and from the protection offered by
a potential ISF. In both of the latter cases original contractual obligations towards lenders remain unchanged: although the cost of these obligations is cushioned by a market (swap) or institutional (ISF) mechanism, the lenders would not have to incur any losses. By contract, interest forgiveness would translate into lower cash flows and loss of revenue for all creditors that grant it, unless their income loss is absorbed by a publicly-financed institution.

The Rohatyn proposal (1983)(9)

This plan combines concessional interest relief, long-term debt rescheduling and debt service payments that are adjusted as a function of the debtors' export revenues. It draws on Rohatyn's earlier success in resolving New York City's fiscal crisis with the creation of the Municipal Assistance Corporation (MAC). Based on that precedent, Rohatyn recommends the creation of a "developing-country MAC" that would reschedule commercial and official bilateral debt, and stretch out short-term debt to maturities of 25 to 30 years. The "DCMAC" would facilitate the rescheduling by offering its own long term bonds in exchanged for developing country debt. In other words, there would be a change in the ownership of risk assets.

The key features of Rohatyn's plan is interest relief. DCMAC bonds would carry a fixed concessional rate (6 dper cent was proposed at the time) that would be passed on

to the debtors whose debt is rescheduled. Banks that accept those bonds in exchange for their original loans would incur an immediate loss, due to the lower present value of the revenue stream on the bonds. As a compensation for that sacrifice, they would acquire assets in a better risk category. They would also be permitted to write off the revenue loss. For their part, industrial country governments would guarantee the agency's bonds and underwrite its potential debt-service losses on the loan portfolio it has acquired from the banks.

A final, important feature of the Rohatyn proposal is that the debtors would commit themselves to maintaining debt service equivalent to 25 to 30 percent of their export revenue. This recognizes the linkage between export and debt-servicing capacity, and states that debt-service ratios in excess of the proposed limits are unsustainable in practice. But, despite its potential merits for HICs with severe debt overhangs and uncertain export prospects, this early plan shares the cost implications, organizational complexity and absence of political support of other debt relief proposals.

The Bradley "Proposal for Third World Debt Management" (1986).

This is a hybrid and ambitious expansion of the Baker Initiative. It centers on annual Trade Relief Summits that would include the World Bank, Commercial banks and

creditor governments. These summits would overcome the logistic problems created by the fragmentation of the debtors' respective negotiations with two separate creditor "clubs": the London Club of commercial lenders and the Paris Club of bilateral official creditors.

Like Secretary Baker, Senator Bradley envisaged a three-year period for the implementation of his plan. During that period consecutive annual Summits would agree to provide a combination of concessional interest and principal relief, as well as additional lending. Debt relief in each of the three years would amount to a maximum of three percentage points off actual interest rates and three percent write-off of all outstanding commercial and bilateral official loans, and to be forgiven by them. The actual amount of relief to any one eligible country would be negotiated under that ceiling.

Reciprocal commitments of debtor and creditor nations would be, for the former to undertake domestic reforms, and for the latter to ensure a better trading environment for developing countries. Finally, as in the Baker initiative, the multilateral development banks would have to increase their lending by $3 billion per year, over three years. However, recognizing that the commercial banks' principal aim is to lower their risk exposures to HICs, the Bradley plan does not provide for new commercial lending.

In aiming to provide debt relief, Senator Bradley's proposal is more ambitious than the Baker Initiative.
It is also more pragmatic than the latter. For instance, the proposal deliberately excludes new bank lending (as noted earlier, commercial lending failed to meet the Baker targets), and the suggested level of debt relief, though limited, anticipates the needs of countries with severe debt overhangs. This proposal's main weaknesses are its short time horizon of only three years, and the budgetary implications of interest and principal concessions by official creditors.

The Kerry proposal (1986)\(^{(11)}\)

This plan offers a more complex form of inter-rate relief. Senator Kerry advocates the creation of an International Debr Program (IDP), to be managed by the UN's International Trade and Finance Development Council. IDP would relate debt service to a given debtor's trade balance and combine interest forgiveness, debt service capping and debt rescheduling.

Debt-service capping would make payments a function of trade surpluses. If the surplus is 20 percent or less of a country's exports, debt-service payments would be limited to 20 percent of exports and increase proportionally, in line with the surplus. For countries with trade deficits, debt would automatically be rescheduled according to a progressive scale, based on the ratio of the trade deficit to total exports. A deficit equal to 20 percent of exports would entitle the country to

automatic rescheduling of 20 percent of its debt, etc., subject to a ceiling of 40 percent.

All rescheduled amount would be capitalized and entitle the debtor to interest relief. For the first five years all interest on rescheduled debt would be paid by the IDP. For the next ten years, interest would be capped at 3 percent, with the remainder paid by the IDP. Finally eligible debtors would establish a reserve against future default, equivalent to 10 percent of the relief they have received.

A major difference between the Rohatyn and Bradley proposals and the Kerry plan is that, under the latter, commercial lenders would not suffer a loss of revenue. Industrial nations would fund the IDP's disbursements in a manner proportional to the trade benefits they enjoy as a consequence of the debtors' relief. The difficulty of gaining public support for that cost feature is a major stumbling block.


This is one of the few debt plans made by a commercial bank that is also a creditor to NICs. It central feature is that the amount of interest-rate relief would be set so that debt service could be a "reasonable burden". In each case, the amount of relief would be determined in light of the debtor's exports and GDP. Relief would be granted equally by all

existing creditors, but would exclude trade credit.

Rather than being forgiven, the amounts by which original interest charges are reduced would accrue to lenders in the debtor's local currency at a pre-agreed exchange rate and would be available for conversion into equity investment in the debtor country. Finally, relief would be subject to a ceiling and future interest defaults or arrears would be covered by an Insurance Fund. The fund would be managed by an existing multilateral bank and capitalized by commercial, bilateral official and multilateral lenders in proportion to their exposure. The World Bank and IMF would oversee the implementation of the relief plan, apply the necessary conditionality and commit themselves to continued lending to the debtors concerned.

This plan has several merits. Local currency balances could serve to promote VDR through debt-equity swaps; the World Bank and IMF would set surveillance of conditionality criteria; there would be a case-by-case approach. Moreover, it could serve to stimulate new commercial lending by typing it to the disbursements of World Bank loans, and the debtors would have to forgo certain interest-rate concessions if commodity prices rise. However, on the debit side one should stress the risk of inflation, caused by the expansion of the domestic money supply in the debtor countries.

The Dornbusch plan (1988)(13)

This proposal by a leading US academic takes Nova Scotia's approach one step further. It advocates that all

interest payments in foreign currencies be suspended for an undetermined period, and accrue instead in the creditors' favour in local currencies. This could ease the way for debt-equity swaps, as local currencies could be reinvested locally, but not repatriated. As a complement, debtors would undertake major policy reforms. This plan shares the inflationary risks of Nova Scotia's proposal.

The Miyazawa plan (1988)(14)

This second Japanese initiative was presented at the 1988 Toronto Summit. Its structure is threefold and combines menu options and interest reduction. First, debtor nations would securitize part of their debt, with principal guarantees through liens on their exchange reserves and on the proceeds of the disposal of state-owned assets. Second, the remaining, unsecuritized debt would be rescheduled with grace periods of up to five years, during which interest payments could be lowered, suspended or forgiven. Finally, multilateral and bilateral agencies would increase their lending to countries that had taken the first two steps.

The main drawback is that countries with scarce reserves would not be able to provide collateral security for principal repayments. Eligibility to this plan would thus be restricted to debtors that have sufficient foreign-exchange reserves.

Debt relief through the reduction of debt stocks

Most debt reduction plans share the feature that ownership of risk assets would be transferred to an IDP-type agency, in exchange for its own debt obligations. This transfer of ownership would sever the link between private creditors and official debtors, and insulate creditors from any further deterioration in the debtors' creditworthiness, thus protect the international financial system.

The Kenen plan (1983)\(^{(15)}\)

This proposal was the first to recommend the creation of a new agency, the International Debt Discount Corporation (IDDC), envisaging that it could function within the IMF. IDDC's capital would be subscribed—in paid-in or callable form—by industrial countries. In exchange for its own bonds IDDC would purchase debt at 90 percent of face value—a low discount, given today's secondary loan prices. IDDC bonds would have a final maturity of 15 years, a five-year grace period and a yield tied to US Treasury bonds. They would be tradable. IDDC would reschedule the loans it had purchased to the same final maturity, but with a grace period of only three years, and a cost to debtors of a quarter percent above the issue yield of the new bonds. Again the terms of the proposed reschedulings have been surpassed by recent market practice.

The principal merit of Kenen's scheme is that, in being the first to propose reductions of debt stock facilitated

by a new international, publicly funded facility, it has become a "generic plan". Its obvious cost is the need to appropriate public funds to underwrite IDDC's capital and potential losses on the loans it had taken over.

Though subsequent debt-reduction proposals vary in coverage and detain, they mostly follow Kenen's broad principles. They generally also share its costs. For example, the Sengupta Proposal(16) of 1988 envisages an IDDC-type facility, to be created in the IMF (the IMF Debt Adjustment Facility). Similarly, the Mistry Proposal(17) recommends the creation of a Debt Restructuring Facility, to be administered as a special World Bank Program. By contrast, Sachs (18) recommends purchases by the World Bank itself, in exchange for its own bonds.

The Robinson plan (1988)(19)

This plan is more ambitious than its predecessors. It combines debt reduction with voluntary new


lending. The plan's central structure is a new international debt agency, the Institute of International Debt and Development, (I2D2). I2D2 would be a joint venture of the World Bank and IMF and rely heavily on their staff. Sponsoring governments would provide its equity capital.

I2D2 would negotiate case-by-case agreements with debtor countries if the latter agreed to participate, they would have to commit themselves to growth-oriented policies. All participations by sponsoring and debtor governments would be completely voluntary.

With creditor banks I2D2d would negotiate the repurchase of debt at a discount, in exchange for its own obligations. These would be of two kinds: floating-rate dperpetuals, and participidpating preferred stock. The purchase discount would be determined in light of the probability of debt service by the debtor, of the secondary-market price of the debt involved, and of concessions that are deemed appropriate to make debt service more sustainable. In return for that discount I2D2d would grant the debtors "meaningful concessions" during the adjustment period.

I2D2 would also reserve the right to subordinate the debt so acquired to all future debt of the same borrower, to pave the way for new voluntary lending to that country. However, both the original concessions and the subordination could be suspended by I2D2 if the debtor(s) were to deviate from agreed adjustment plans or to exceed targets for new senior
lending. Given the subordination feature, and to avoid free-rider problems, all the commercial debt of a given country would either have to be acquired by 12D2, or treated comparably.

In Robinson's estimate, up to $250 billion in commercial debt of the Baker 17 would be eligible for repurchase. Assuming the total amount were repurchased at 100 percent of par, 12D2 would have to issue a maximum of $15 billion in its own obligations, respectively as to $12.5 billion in perpetuals and $25 billion in preferred stock. Assuming a 10:1 gearing ratio, 12D2 would require a 12.5 billion in equity participations by sponsoring governments, either paid up, or collable. Such capital would be kept as reserve by 12D2.

One weakness of this proposal is that if 12D2 subordinates the debt it has acquired from banks, its risk exposure could be considerable. On the other hand, that subordination would be da "carrot" for new lending. As another carrot to promote the enforcability of this essentially voluntary plan Robinson suggests that bank regulators treat discount from the debt's face value as an eligible reserve in the Banks' base capital, or that its write-down be spread out over time. However, it is not clear how a discount i.e., a loss—could become an eligible reserve.

Robinson proposes to deal with free riding in two ways. Non participants would either be offered low-yield exit bonds, or be mandated by regulators to mark the loans
concerned "to market", without the benefit of the special reserve treatment or spread write-downs the participants would enjoy. But, as the proposed inclusion of discounts in the banks' reserves is questionable, that part of the stock loses some of its "clout".

The UNCTAD plan (1988)

This proposal was sent out in UNCTAD's Trade and Development Report 1988, and calls for across-the-board debt reduction. UNCTAD starts from a medium-term baseline scenario for the Baker 15, and recommends once-and-for-all debt forgiveness of 30 percent of the commercial bank debt of those countries (equivalent, in UNCTAD's estimate, to 25 percent of their total debt).

Simplicity is the principal advantage of UNCTAD's approach: the banks would act directly to make write-offs, without the intermediation of a new debt facility. However, this does not tackle the question of enforcability and free riding, except through burden sharing with the debtors (the proposed discount of 30 percent is far below average market discounts of around 50 percent). The cost of the proposed forgiveness is estimated to be compatible with the banks' existing provisions.

The sole condition to be imposed on debtors would be to allocate the entire amount of interest savings estimated at $10 billion in the first year-to investment in export industries, so as to generate additional foreign exchange
when exports grow. Domestic consumption would only expand later, in line with GDP growth.

UNCTAD estimates that debt forgiveness of that magnitude would immediately raise income growth in the Baker 15 to 7.2 percent, and that average growth of per capita income over the next five years would reach 3.1 percent, or 2.5 percent more than in the baseline without forgiveness. These projected growth rate are substantially above the World Bank's "high case" scenario, presented in the 1988 World Development Report.

The Gorbachev plan (1988)

Though laudable, this plan may be somewhat disingenuous. The U.S.S.R. is a major debtor in its own right and its Foreign Trade Bank has only a very limited risk exposure in HICs.