

FROM: P MOUNTFIELD
DATE: 24 March 1988

NOTE FOR THE RECORD

DEBT OF POOREST/MOST INDEBTED COUNTRIES

PARIS CLUB DISCUSSIONS 22-24 MARCH

A. Preparations.

Talking to the other G7 delegations, it soon became clear that Sir G Littler's paper dated [3] March had not been passed down from the G7 Deputies/Sherpas to those attending the Paris Club. I therefore distributed additional copies (to all save Italy, which was being unhelpful).

Milam (US) told me that their real problem was Egypt - not the alleged legal and budgetary problems which Mulford had quoted at Val David. Some figures: halving the interest rate to the 16 or 17 poorest Sub-Saharan countries would cost USA about \$60-80 million a year, of which 90% was for Zaire. This would have to come out of the existing Foreign Assistance budget for Africa, largely at the expense of other African countries. He acknowledged that this would probably unlock additional funds from other countries, but not from US. But if Egypt were added, it would cost another \$250 million a year, also at the expense of other Africans. I therefore concentrated next day on strengthening the ring-fence against Egypt (arguments we had left out of Sir G Littler's paper).

Canada belatedly found the paper which Wendy Dobson had received, and promised full support. Lajeunesse, in Trichet's absence saw little point in continuing the discussion. Von Korff (FRG) said he was working hard to swing the German position and had almost persuaded Bangemann. Genscher was on board. It remained

to convince Stoltenberg.

B. Breakfast 23 March: G5 only.

This was the only subject discussed apart from Nigeria - (see separate note). Trichet was in the chair; Lajeunesse kept quiet; de Rosen who flew back overnight from Caracas, was mischievous and very negative. But all the others spoke off the record, and constructively.

Trichet began: at Val David, Sherpas had been very anxious to avoid a showdown on this subject at the Summit. He had therefore agreed to see if it was possible to reach a consensus in the Paris Club. I recapped the UK paper. Milam said he hadn't studied it fully (ie Mulford hadn't passed it on to State Department). But his first impressions were negative. He repeated the numbers. No ring-fence would stand up against Egypt: Mubarak had a private line to most Heads of Government, as experience on the IMF programme proved. However, the question had not yet gone to Ministerial level. It would be easier to accept the French proposal (to shave margins on non-concessional loans). But even that could be awkward - Baker could not dictate terms to Exim, but the President could. (Comment - nonsense: John Bohn of Exim is Baker's man).

Trichet very helpfully said that wasn't the issue. Exim had not provisioned against loss on sovereign debt. Without interest relief, some of its loans would have to be written off. There would be a budgetary cost in the end, since the cost was not being recovered from policy-holders through premium. He argued that Milam was over-simplifying the issue. But Milam said that the Foreign Assistance Programme already provided \$800m a year to support Exim (mainly tied-aid credits, of course).

Von Korff repeated the internal German politics. His government clung to the fiction that sovereign debt would eventually be repaid. History showed that in the 60s and 70s, FRG (and others) rescheduled a lot of debt on concessional terms - so did we all.

Our ECAs were then making profits, and could afford it. But the impact of the debt crisis in the 80s made us all adopt a tougher line for a time. Now, some countries were already offering concessions: eg, Italy (followed Andreotti's visit to UNGA 1986) had bilaterally offered very short terms to Mozambique, Tanzania and Somalia, in its own sphere of influence. The Italian argument (in his own recent visit to Rome) was that if each creditor did this for his own clients, the overall result would be the same as in the UK proposal: but that ignored FRG and Japan! And undermined credit or solidarity.

Kondo (Japan) said that a concession to SSA alone would not cost Japan very much but Japan was already doing a lot, more directly, to help SSA, with large yen loans at low interest rates, so many in Tokyo thought they had done enough. Personally he thought Japan would 'not be the last to join a consensus' if one emerged, but at present he would follow the tough US lead. If the Chair would take a strong initiative, however....?

Trichet picked this up. France was, traditionally, concerned about the risk of contagion; and because of its large exposure in SSA, concessional interest rates would cost it dear. But as Chairman, his responsibility was to see if a consensus would send the right signals to the Summit. Was such a consensus possible, eg around the UK, or the original French proposal? National positions seemed to be evolving (slowly, said Von Korff and Kondo!) He would therefore organise another plenary discussion, but he recognised we would all speak less freely there. Von Korff said most of the others would follow if France, FRG and Japan followed the British lead. Then Rosen burst in unshaven, hot from Roissy, Washington (IBRD African donors' meeting) and Caracas (IAADB). His arguments are reported below.

C. Heads of Delegations lunch 23 March (19 Delegations)

Walking down to the hotel, I briefed Dinkelspiel (Sweden) privately on what had happened at breakfast (and at OECD two days before - see Mrs Thomson's separate note).

Trichet began as before, with references to Val David (or La Sapiniere, as he calls it). We should see if a collective position was possible. He called me first.

I argued that since the original Lawson proposals, we had watched the successful ESAF proposals and the IBRD concerted African proposal. We saw all three as complementary. The Lawson proposals had three elements. On RTA, we hoped others would follow the UK and FRG example; for that reason, rescheduling concessional loans on concessional terms was not good enough. We welcomed the move to long-term rescheduling and regretted that even for Togo (previous day) the Club had not conceded 20 years. But if commercial debt was not to snowball, something had to be done about interest. There seemed to be three main objectives. The budgetary problem was only one of timing, since without interest relief the debts would have to be written off eventually. The creditworthiness argument was misconceived because SSA countries were commercially uncreditworthy, while government credit was a matter within our own control. The contagion argument was more serious. We thought that concessions to SSA could be ring-fenced if a triple test were applied: Very poor meant 'IDA-only' in 1988, ie per capita income below \$450 pa; Egypt was \$680; Nigeria in 1985 above \$700. 'Heavily indebted' could best be measured by an interest/export ratio, say 15%, since principal could always be rescheduled; alternatively the IBRD debt/export ratio could be considered. 'Strong adjustment effort' meant, at least initially, an SBA. The Club already applied these three tests, though not very precisely, in deciding to grant SSA countries very long rescheduling terms.

Dinkelspiel, by prior arrangement, joined in. This subject was on the agenda - Development Committee, OECD Ministerial (Sweden in the chair this year!), Summit, UNGA (Wass Report etc) and Annual Meetings. We couldn't ignore it.

Milam, resuming his public face, disagreed. US was firmly opposed, for budgetary and Congressional reasons. As for contagion, the

more arguments we used, the easier it would be to break through the ringfence. If anything was to be done, he liked the French idea of shaving margins on the interest rate charged on rescheduled commercial debt. Even that would require Presidential intervention.

Lintjer (NL) took his usual Calvinist stand. All he would do was reschedule old aid loans on IDA terms.

Jean de Rosen (Fr), by now shaven, ran the 'creditworthiness' and 'budgetary cost' arguments, and revived the earlier French line that concessional terms would tempt other countries to reschedule (eg Kenya). He rubbished the Wass Report in passing. Then he pulled his rabbit from the hat: the IBRD had just abolished the whole problem! Their figures, produced at last week's meeting of African donors, proved that their own estimate of the African financing gap had already been over-funded by unexpectedly-generous pledges of bilateral aid - \$6.3 billion instead of \$3.5 billion, and more than half of it genuinely additional. Then he qualified it - 'assuming that it's mainly disbursed in the first two years and really goes to the poorest countries'. (Trichet was visibly annoyed at this intervention, not for the first time.)

Canada supported UK, Belgium saw no case for change. FRG repeated the helpful earlier line, while restating the official government position. Austria had a technical problem about reopening old agreements (to which Sweden had the right answer). Australia, still preoccupied with a heavy Egyptian exposure, was unhelpful and muddled. Burke Dillon (IMF) challenged Rosen's interpretation of the IMF figures. Speaking personally, she threw in a new idea - why not let countries who were prepared to do concessional rates do so, on condition their claims then took priority over those of creditors who continue to charge full commercial rates. (I could have kissed her.) Norway supported Sweden; Switzerland ensured Calvinist solidarity with Netherlands; Japan sat uncomfortably on the fence; Italy was oracular (Rastrelli has

just been made an Ambassador); Ireland, with high exposure in Nigeria, wanted strict ring-fencing; Denmark was negative; Spain still worried about contagion.

Trichet asked us all to make sure we had support 'at the higher political level' for the views we had expressed, because the subject was now very political indeed. He tried to get a 'lowest common denominator' consensus round the twin French proposals (for zero margins on rescheduled commercial debt and concessional terms for old aid loans) but even that did not command unanimous support. So he ended by circulating a draft consensus note by the Secretariat, promising further discussion next day.

D. Working Group meeting 24 March, 8.30 am.

Trichet withdrew at the last moment, leaving de Rosen (who is violently opposed to our proposals) in charge. He took us through the draft non-paper. I needn't record the full discussion, since the end-product is the version attached at Annex A. But the main points were these.

a. IMF threw some doubt on the validity of the IBRD figures quoted by Rosen. In any case they were aggregates, and concealed over-funding for some countries which meant big financing gaps for others. Milam said that recent US analysis of existing IBRD figures showed no net outflows and that they had concluded that only 4 or 5 of the original list of 16 or 17 countries really warranted special assistance.

b. US - inconsistently - objected to my amendment spelling out the three simultaneous and specific tests of eligibility. His argument was that Egypt would claim it qualified on one, perhaps two of them and therefore deserved special treatment. In the end I compromised on listing the tests without putting numbers on them; but reminded everyone that they were meant to exclude Egypt and Nigeria.

c. Japan insisted (on instructions from Tokyo) on inserting references to 'equivalent measures' at the end. I didn't object.

In Japan's case these might genuinely be additional, though the section would provide a let-out for others.

d. Austria, with support from FRG and Belgium, raised a complicated technical point about the re-consolidation of previously-rescheduled debt. The issue here is how best to carry through any concession without reopening old agreements. It applies mainly (not entirely) to those countries who reschedule or refinance at fixed rates, unlike UK practice.

The final text was approved ad referendum in capitals (several had reservations about accepting even this minimal document). Its status is still a bit unclear. It is to be discussed again at the April Paris Club. Meanwhile it can be used for briefing purposes, and will no doubt surface again at the next G7.

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March 24, 1988

**HARMONIZATION OF THE CREDITOR COUNTRIES' POSITIONS
WITH RESPECT TO THE DEBT TREATMENT OF THE POOREST
AND MOST HEAVILY INDEBTED COUNTRIES**

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There has been a growing acceptance among creditors and international financial institutions that the debt problems of many low income countries, especially in Africa, are exceptionally grave and merit additional flows. In that context, several specific proposals for debt relief and additional concessional flows have been put forward, which could be applied on a case by case basis. The last World Bank - IMF Development Committee expressed "great concern about the exceptional difficulties confronting many low-income countries, especially the seriously indebted in Sub-Saharan Africa", and agreed that there was an urgent need for action.

I - DEBT RELIEF AND ADDITIONAL CONCESSIONAL FLOWS PROPOSALS

Irrespective of the question to know whether debt relief is the most appropriate and effective means of channelling additional concessional financial flows, several practical proposals have been put forward.

Some of them are already implemented :

- Agreement in 1986 on the eighth replenishment of IDA ;
- The Establishment of the IMF's Structural Adjustment Facility, and very recently the Enhanced Structural Adjustment Facility, to enable the Fund to provide financial support on concessional terms for the adjustment efforts of low-income countries ;
- The lengthening of the period of reimbursement up to 15 or 20 years for the poorest and most indebted countries undertaking adjustment efforts : (already been applied by the Paris Club to 7 Sub-Saharan countries).

- Agreement in 1988 on the World Bank co-financing programme.

Other proposals are still under examination (in chronological order) :

- The setting up of a Special Facility for Development and Debt Reduction, which would help IDA eligible countries having an IMF programme and a history of "real effort" to service external debt. Independently, there would be a concessional window for the IMF's CFF.

- The "Lawson Plan" for "the poorest and most heavily indebted Sub-Saharan African countries which are pursuing satisfactory economic policies". This plan entails mainly the conversion of aid loans into grants and the reduction of interest rates on rescheduled debts "well below" market levels.

- A recently launched Nordic initiative, which would establish a Trust Fund to help IDA -eligible countries refinance their maturing IBRD debt on concessional terms.

- The very recent recommendations of the United Nations Advisory Group on Financial Flows for Africa, chaired by Sir Douglas Wass, GCB.

II - FOLLOW-UP OF THE PARIS CLUB METHODOLOGICAL DISCUSSIONS

One conclusion of the methodological session of the Paris Club, based on a World Bank presentation, on November 19, 1987, was that discussions of concessional rescheduling or alternative approaches would have to continue.

Interest capitalisation at commercial interest rates has contributed to the growth of total and future debt burdens. The World Bank has estimated that Zaire's interest capitalisation over the 1979-85 period added about \$ 1 billion -20 percent of its total debt (at end 1985)- and almost offset the greater concessionality of new borrowing over the period. Zaire is the extreme case but the problem is that, despite the downward drift of interest rates, the existing procedures of the Paris Club, while providing substantial short term relief, create a longer run cost that would limit a debtor's ability to return to creditworthiness.

It has already been recalled (1) that two means are possible to tackle this problem :

- a direct lowering of moratorium interest rates on commercial credits to be consolidated ;

- additional concessional flows, which would effectly refinance the existing debt at a lower cost and permit less recourse to rescheduling.

During the previous discussions, there was a consensus that additional aid flows are necessary, in any case.

However there was no consensus on concessional rescheduling. A number of delegations cited a series of disadvantages, such as : domestic reasons (including budgetary constraints and lack of additionnality) or more strategic reasons, including the risk of "contagion" to middle-income countries, the risk of creation of a new incentive to further reschedulings, the belief that concessional rescheduling would undermine a debtor's future financial standing and access to new private and official credits, the problem of inequality of treatment among creditors and the concern that concessional rescheduling would open the door to intervention by budgetary authorities, if it blurs the distinction between aid and rescheduling, that could potentially limit the scope for the Paris Club to act.

(1) Paris Club methodological sessions of July 21, 1987 and of November 19, 1987

On the positive side, some delegates argued that rescheduling on the basis of reduced interest is the most simple, equitable and direct means to tackle the problem pertaining to the growing indebtedness due to repeated consolidations, and would occur either voluntarily by the Paris Club now or unilaterally through defaults that could conceivably spread from debtor to debtor in the future.

They argued that such special treatment should be restricted to a closely-defined group of countries, for example, those who are both the very poor, heavily-indebted, and committed to a strong adjustment programme and a prompt and sincere observance of the Paris Club corresponding agreements. Other criteria could also be considered. Special treatment could be granted case by case.

They believed that these definitions would prevent concessions spreading to other countries, and would give them no incentive to seek unnecessary rescheduling. The damage to creditworthiness was illusory since these debtors had no hope of an early return to the market.

There have also been discussions about other approaches, consisting of :

1/ - applying concessional rates, in a multilateral approach, to rescheduled ODA debt. Several creditors already reschedule those loans on a concessional basis. Some creditor countries are no more concerned, since they have cancelled ODA debt in appliance with UNCTAD resolution 165 (5.IX), passed in 1978, and, since then, have converted new ODA loans into grants for the poorest countries.

It could be decided, to take it into account, to modify the present relevant clause in the Paris Club agreed minute.

2/ - reducing (possibly to zero) the spreads or fees applied to the market rates by the creditor countries, in the bilateral consolidation agreements, for the poorest and most heavily indebted countries.

3/ - If legal and other impediments for some creditor countries prove insuperable, alternative ways of channeling funds to achieve the equivalent of direct interest rate reduction could be explored, such as the provision of non project grant assistance to the poorest countries, in consideration of their outstanding official debt and the World Bank assistance to them.