

Debt Relief –
Principles and
Practice
Jamaica's Experience

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BACKGROUND

Many countries have sought debt relief in response to the severe difficulties which they have had in honouring their debt service obligations. These debt servicing difficulties are the outcome of massive debt accumulation to which several countries resorted in the mid-1970s in the wake of the oil crisis.

Two rounds of sharp increases in the world price of oil in the 1970s had a staggering impact on the import bill of the non-oil exporting developing countries. At the same time, low prices for primary commodities exported by these countries led to sharp declines in export earnings. Two options were available to affected countries. They could either adjust by sharply curbing spending on imports in line with their reduced export earnings or they could maintain existing levels of expenditure through recourse to borrowing. Many developing countries chose to borrow.

Funds to lend to financially strapped developing countries were readily available during the latter half of the 1970s. Oil exporting countries which had formed the cartel OPEC amassed substantial revenues as a consequence of the oil price increases. It was these funds, petro-dollar, which formed huge deposits in the international banks and ultimately became the source of external financing to the non-oil exporting countries.

Borrowing was particularly attractive in the 1970s because of the low interest rates which existed at the time. However, many of the loans which appeared cheap when negotiated carried a variable rate of interest. It meant that any increases in interest would have an immediate effect on the outlay for debt payments.

This is precisely what occurred in the very late 1970s and early 1980s when economic conditions in industrialized countries necessitated dramatic increases in interest rates. Developing countries suddenly found themselves burden with debts which were unserviceable.

The extent of the difficulties confronting indebted countries was starkly evident in 1982 when Mexico declared to the world that it was suspending payments on its debt for a period of no less than six months. This heralded the beginning of what is commonly called ‘the debt crisis’.

The consequences of several countries following Mexico’s lead and ultimately suspending payment to their creditors posed a severe threat to the viability of the world financial system. For individual countries, honouring their debt commitments meant shelving their development plans, sacrificing economic growth and embarking on programmes of economic austerity. The imperative for creditor and debtor alike was to find measures to tackle the problem of debt. Arising from these circumstances, an array of debt relief measures has evolved.

DEBT RELIEF

Typically, a country seeks relief on its debt when it finds that it is unable to meet either its payments of interest or principal or both when they fall due. The problem usually arises when a country’s holdings or earnings of foreign exchange are insufficient to cover its debt payments.

Debt relief can take the form of debt rescheduling, debt refinancing, debt conversions, or debt write-off or forgiveness. These are conventional forms of debt relief which arise out of negotiations or consensus between creditor and debtor. However, countries can and have obtained debt relief unilaterally. This occurs when involuntarily countries cannot make payments of principal and interest when they fall due and arrears accumulate. This is often referred to as “**de facto relief**” since the country’s intention is to pay but it finds itself temporarily unable to do so. However, a country may declare a moratorium on its debt and unilaterally suspend payments. Mexico, Cost Rica, and Peru, are examples of countries which have done so. Such action on the part of a country represents a fundamental breach of contract. The consequences are usually swift and harsh.

That country is usually isolated in the international financial community as normal flows of external financing and trade are severely disrupted. Most countries seek to maintain normal creditor/debtor relations by agreeing with their creditors the form that debt relief will assume. Thus it is rescheduling or refinancing arrangements, debt conversions and write-offs that occupy the forefront of debt relief measures.

Debt rescheduling occurs when the terms of an existing loan are altered to re-phase the schedule of interest and principal payments due to creditors. The rescheduling of payments usually result in the postponement of all or part of debt service payment falling due over a specified period of time. Debt rescheduling is therefore a useful mechanism through which short-term cash flow relief can be obtained.

Debt refinancing involves the contracting of a new loan to repay or prepay an existing loan or group of loans. Countries with severe debt difficulties use debt refinancing arrangements to replace an old loan with a new loan on better terms. The refinancing loan is likely to attract lower rates of interest or have an extended repayment period or in any event provide more favourable borrowing conditions that existed under the terms of the original loan. Debt refinancing and rescheduling constitute debt restructuring arrangements. Other forms of relief fall under the ambit of debt reduction mechanisms.

Debt conversion schemes are among the newer techniques structured to provide relief to an indebted country. Debt conversion refers to the mechanism by which a borrower can change his liability from loan debt to some other form of liability such as equity or bonds. Foremost among debt conversion schemes are those that convert loan debt into equity. The impact on a country's debt is to reduce the amount of debt outstanding and in turn this leads to a reduction in debt service payments. In general, debt conversions are confined solely to commercial banks debts.

The write-off or forgiveness of debt occurs when a loan is extinguished, wholly or in part, by agreement between debtor and creditor. Debt write-offs result in the direct reduction of the total amount of outstanding debt.

The type of debt relief that a country can obtain is closely related to whom the lender is. Loans can be obtained from three sources. One source is the international financial organizations. These include the World Bank, the International Monetary Fund, regional development banks and other multilateral agencies. Another source of funds is bilateral loans which obtain from governments, their agencies, as well as official export credit agencies. Loans can also be obtained from private creditors. Primarily, these commercial banks and other private financial institutions but also include manufacturers, exporters and other suppliers of goods who extend credit.

There is little scope for debt relief from multilateral lending agencies. Debt reduction measures such as write-offs and debt conversions are not available options for multilateral debt. In addition, these institutions insist that debts owed to them cannot be rescheduled since such action would impair the impeccability of their first class rating in world capital markets.

Multilateral lending agencies generally take the view that their role is to provide financial support for economic programmes that will correct balance of payments difficulties and ensure the economic viability of the countries. The multilateral agencies unlike other groups of creditors, will lend only when countries are in financial difficulties. In a sense, the loans provided can be viewed as indirect or 'de-facto' refinancing. The loan from the multilateral agency provides incremental foreign exchange which is a form of cash relief. Multilateral agencies, by and large, can be viewed as providing indirect debt relief.

Bilateral debts are amendable to write-offs, refinancing and rescheduling. Creditor governments under recent debt initiatives have fully or in part cancelled the debts of a country or group of countries. Refinancing arrangements have also been negotiated between the rescheduling of existing debt owed to bilateral creditors. Although reschedulings can be negotiated bilaterally between a country and an individual creditor, very often rescheduling agreements take place in a multilateral forum between a debtor country and a group of creditors. This forum is referred to as the Paris Club. It is the chief mechanism for the rescheduling of official bilateral debt.

The Paris Club is an informal association of creditor governments and their agencies, usually from industrialised countries. Representatives from these countries convene from time to time in Paris, France, to consider debtor countries' cases for debt relief by means of rescheduling. The Paris Club first met in 1956 to consider a case for rescheduling Argentina's debt. In addition to official bilateral agencies, the Paris Club consist of observers from the World Bank and IMF which have interests in virtually all cases considered by the Club. A pre-condition for a country to obtain rescheduling is that it must have in place an economic programme approved by International Monetary Fund. The rationale for the Fund's stamp of approval is that it represents a guaranteed to creditor countries that the debtor country will manage its economy in such a way to ensure its future ability to repay its bilateral debts.

Private creditors, in particular, the commercial banks are willing to consider the rescheduling, refinancing or conversion of the debts owed to them. Since commercial banks are in the business of making profit, they are unwilling to write-off loans to debtor countries and suffer huge losses on their balance sheets. Typically, commercial banks refinance debt. That is commercial banks will allow a debtor country to contract a new loan with improved terms to replace an existing debt. Similar to bilateral creditors, commercial banks prefer to meet as a consortium rather than individually and the forum for this is the London Club. A significant departure from official bilateral rescheduling agreements is that commercial banks without exception do not reschedule or refinance interest payments. Interest represents a stream of income to the commercial banks with which to pay their shareholders. Thus, while repayments of principal may be deferred, interest remains sacrosanct.

Debt conversions fall into the realm of financial engineering. Arising from the immense difficulties faced principally by Latin American countries which were heavily indebted to the commercial banks, a number of techniques were developed to provide relief to these countries and reduce the threat of a collapse of the international banking system. Among these were the developments of debt conversion schemes.

A debt equity swap or debt capitalization takes place when a loan debt denominated in foreign currency is purchased from a commercial bank at less than the face value of the debt. It is purchased at a discount. The purchaser is usually a potential investor to a country. The investor purchases the debt at a discount from a commercial bank in the 'secondary market', and then presents the debt obligation to the central bank of the debtor country. The debt is redeemed by the central bank in local currency at or near face value and the proceeds are used by the investor to acquire equity investment in a new or existing enterprise.

Advantages accrue to all three parties. The overseas commercial bank removes a potential bad debt from its books, the investor pays substantially less foreign currency for his local investment, and the debtor country benefits from a decrease in its stock of external debt while attracting new investments. Critical to the process of debt conversion is that the commercial bank must be willing to relinquish its loan at a loss, by selling it at less than face value.

A country's debt relief programme will clearly depend on the structure of its debt, and whether the objective is short term cash relief, a longer term reorganization of its debt portfolio and ultimately a reduction in its debt and debt service burden to manageable levels.

JAMAICA'S DEBT RELIEF PROGRAMME

Typical of so many other countries in the latter part of the 1970s and for much of the 1980s, Jamaica experienced rapid growth of its external debt and debt service. Jamaica's medium and long term public and publicly guaranteed external debt at the end of 1970 amounted to US\$154 million. This was equivalent to a 12% share of Jamaica's total output (GDP) and a 29% share of exports of goods and services. By 1975 the debt had more than quadrupled. By end-1980, the debt had almost tripled again and amounted to US\$1.87 billion. Jamaica's debt stock grew further two-fold by end-1985 to US\$3.59 billion before peaking at US\$4.15 billion at the end of December 1990.

Since then the debt has been declining and at the end of 1992, Jamaica's external public debt stood at US\$3.67 billion.

The growth in the debt stock was accompanied by substantial increases in debt service. Jamaica's debt service as a portion of exports of goods and services grew from 2.6% in 1970 to 7.4% in 1975. By 1980 the debt service ratio had jumped to 18.5%, moved further to 39.8% in 1985, and in 1987 reached a peak of 47.5%. Currently, Jamaica's debt service is equivalent to 27% of the total export of goods and services indicating some easement in the debt burden.

A consequence of Jamaica's heavy indebtedness is the impediment it has imposed on the country's economic growth and development. From a balance of payment perspective, the debt has led to pre-emption of scarce foreign exchange earnings to satisfy service requirements. This has restricted the importation of capital equipment and basic goods vital to the production process and the overall maintenance of living standards. On the fiscal side, the cost of debt has been onerous. Successive administrations have been constrained in providing the investment in social services and infrastructure consistent with improved welfare standards.

While the overall size of the debt is a severe burden, the problem is aggravated by the structure of Jamaica's debt which limits the degree of freedom in obtaining debt relief. Since the 1980s and up until 1987, multilateral lending agencies have been the largest single source of external financing and accounted for roughly 45% of the total debt outstanding. Since 1987, and up to the present, official bilateral creditors have constituted the single largest category of creditor and account for almost 50% of the total debt stock. Multilaterals are a close second and have an approximate share of 35% of the total debt outstanding. Commercial bank creditors account for 9% of the total at present, the remaining 6% being credits extended by suppliers of commodities.

In terms of debt relief, Jamaica's first priority has been to maximize cash relief from debt service payments. The principal vehicle for this has been debt rescheduling. Accordingly, Jamaica has negotiated several rescheduling agreements with bilateral creditors and commercial banks over the years. Jamaica has also sought to reduce its debt by implementing a debt to equity conversion programme. Most recently, Jamaica has been the beneficiary of some debt forgiveness from four creditor governments, the United States, United Kingdom, Canada and the Netherlands.

Jamaica has had seven rescheduling of its bilateral debt under the aegis of the Paris Club. These have taken place in 1984, 1985, 1987, 1988, 1990, 1991 and, most recently, in 1993. Loans eligible for rescheduling at the Paris Club are those extended directly by the creditor government or its agencies, and commercial credits guaranteed or insured by the government or its official agencies. In addition, the Paris Club stipulates a date, the contractual cut-off date, beyond which debts are ineligible for debt relief. This date is strictly adhered to by the Paris Club and remains unchanged regardless of the frequency with which a country reschedules its debt. Jamaica's cut-off date is October 1, 1983. Only debts which fall due during a specified period (the consolidation period) are rescheduled by the Paris Club. Typically, the length of consolidation period corresponds with the duration of an IMF approved economic programme. In Jamaica's case, the consolidation period has usually been between 12 to 18 months in duration. The sole exception has been the 1993 Paris Club agreement where bilateral debts falling due over a three-year period from October 1, 1992 to September 30, 1995 were rescheduled. The thirty-six month consolidation period is concurrent with an Extended Fund Facility arrangement agreed between Jamaica and the International Monetary Fund.

Jamaica's agreements with the Paris Club have involved the deferral of principal and interest payments in part or in full. In addition, debts which were previously rescheduled and again fall due may be rescheduled once more. Jamaica's seventh Paris Club Accord which took effect on January 25, 1993 resulted in the rescheduling of payments of principal and interest amounting to US\$281.2 million. A portion of this amount relates to debts previously rescheduled under the first four Paris Club Accords.

Debts affected by Paris Club reschedulings are divided into two categories, concessional and commercial. Of the US\$281.2 million rescheduled, US\$141.7 million related to concessional debts and carried terms of a ten year grace period followed by a ten year repayment period. For commercial debts, rescheduling of US\$139.5 million was effected. Repayment terms entailed six years grace followed by a nine year repayment period beginning in the year 2000.

While the Paris Club affords Jamaica a fair measure of debt relief, the annual amounts have tended to decline over successive reschedulings. The principal reason for this is that the contractual cut-off date has made less debt eligible for rescheduling. Notably, Jamaica has announced its intention not to seek further rescheduling. This is of somber significance since no relief is available on some 35% of Jamaica's debt owed to multilateral institutions.

Jamaica first refinanced its commercial bank obligations in 1978. Relief of US\$63 million or 87.5% of principal repayments falling due between April 1, and March 31, 1979 was obtained. Subsequent refinancing agreements were negotiated in 1979, 1981, 1984, 1985, 1987 and 1990.

The 1990 agreement allowed for the refinancing of US\$387.7 million in commercial bank debt. Under its terms, principal repayments which fell due in fiscal years 1990/91 and 1991/92 were deferred to future years. In addition, the interest rate margin was reduced from 1 ¼ % over LIBOR to 13/16% over LIBOR. Debts refinanced under this agreement were grouped into categories or tranches. Debts were designated as Tranche A or Tranche B debts depending on when payments fell due. In the 1990 agreement, Tranche A debts are payable between 1998 and 2004.

The 1987 Commercial Bank Refinancing Package was a benchmark agreement for Jamaica. In it, a provision was included whereby arising Jamaica's commercial bank

could be converted into equity. It is from this provision that Jamaica launched its debt conversion programme in July 1987.

When instituted in 1987, the debt conversion programme aimed at converting US\$185 million of commercial bank medium and long term debt, or approximately one half of the outstanding consolidated amount of US\$365 million. The amount was not substantial as total commercial bank debt requested only 10% of Jamaica's total debt outstanding.

An objective of the programme was to provide and target investment into areas of high priority. Areas of economic activity assigned high priority were:

1. The construction of hotels in Jamaica or the expansion of existing hotels.
2. Investment in existing export processing zones (Free Zones).
3. The construction of factory space.
4. The production, manufacture or processing of export products.
5. Activities generating employment in Jamaica.

The performance of Jamaica's debt conversion programme has been mixed. Over the period July 1987 to June 1989 only US\$15 million had been cancelled under the programme, far from the US\$30 million per annum targeted for conversion. The pace of conversions accelerated after 1989 and by end-March 1993, US\$107 million or approximately one half of the consolidated debt outstanding at the start of the programme had been converted.

Although most projects have been directed towards tourism and exported goods, a few projects have related to the social sector and the environment. One such project involves UNICEF which is to convert US\$4 million over three years for special programmes related to women and development, primary health care and children in especially difficult circumstances (street-children, child abuse victims, teenage mothers). A debt for nature swap was also approved. This involved the creation of a Trust Fund from which the interest derived has been used to maintain two national parks.

Last but not least, Jamaica has been afforded debt relief through debt forgiveness. Canada was the first government to bestow a debt write-off to Jamaica when in February 1990 it forgave C\$93 million in debts owed to the Canadian International Development Agency (CIDA). A year later, the United States followed suit. In August 1991, under the Enterprise for the Americas Initiative, 80% of the US\$272 million owed under the Food Aid Programme (PL480) was forgiven. Subsequently, the government of the United Kingdom and the Netherlands forgave debt service payments falling due between June 1, 1991 and June 30, 1992 and each amounting to US\$14 million.

In January 10 1993, the US Government approved the further cancellation of debts owed by Jamaica. On this occasion, it involved US\$93 million in debts owed by Jamaica to the US Agency for International Development (USAID). The debt reduction exercise was particularly significant in that it sought to optimize the quantum of debt relief by concentrating solely on debts contracted after October 1, 1993 (Paris Club contractual cut-off date and therefore ineligible for Paris Club rescheduling). Overall, 21% of USAID debt outstanding has been forgiven.

CONCLUSION

Despite existing rigidities in Jamaica's debt structure because of a relatively high proportion of multilateral debt, significant progress has been made in alleviating Jamaica's debt burden. Overall, several factors have contributed. Firstly, Jamaica has made tremendous effort at servicing its debt. This has not been without cost as the effects on economic growth and social welfare have been adverse. Secondly, where there has been an inability to service its debt, Jamaica has pursued the negotiation process rather than opt for unilateral action. Remaining integrated in the international financial system has allowed Jamaica to benefit from debt reduction through write-offs.

Jamaica has employed all the relief options at its disposal and has used them effectively and, in instances, creatively. Remaining integrated in the international financial system

has allowed Jamaica to benefit from global debt initiatives, and in particular, to benefit from global debt reduction through write-offs. Debt relief measures, however, cannot be divorced from the wider economic framework. Jamaica's programme of economic reform, especially in term of improving the country's export capability, is vital to achieving levels of debt which promote rather than inhibit economic growth and development.