

The World Bank

Washington, D.C. 20433
U.S.A.

May 25, 1990

Mr. Pieter Bottelier
LA4DR
The World Bank

Dear Pieter,

Attached you will find a note on the possible strategy to clear Peru's arrears to the Bank, and to begin the process of reinsertion into the international financial community.

This is a totally informal outline of a proposal that I have prepared with the assistance of Al Watkins, and is intended only to suggest some avenues to resolve an almost impossible situation.

I hope this note may be of some use to you.

Best regards.

Sincerely,



Francisco Sagasti

Attachment

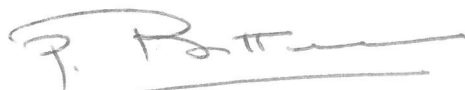
June 6, 1990

To: Mr. Francisco Sagasti:

Re: PERU - Debt-Out

I have received and read with interest your note on a debt work-out for Peru. I thank you very much for your input and views; in particular at this time in which we near a change of Administrations in Peru.

Nonetheless, given the sensitive and almost political nature of the problem, as well as the uncertainties involved in it, I would like to ask you not to circulate the note or elaborate further on it. At the time we reach a specific debt work-out proposal, I will be keen on having again the benefit of your comments.

A handwritten signature in dark ink, appearing to read 'P. Bottelier', with a horizontal line underneath it.

Pieter Bottelier

FACSIMILE COVER SHEET AND MESSAGE

DATE 11/02/90

NO. OF PAGES 4
(Including this sheet)

MESSAGE NO.

TO
Name SR. VICTOR JOY WAY
Company/
Organization

Fax Tel. No. 407598
City &
Country SAN ISIDRO, LIMA
PERU

FROM
Name FRANCISCO SAGASTI

Fax Tel. No. 477-1775

Dept./Div. Name EXT/PRD

Dept/Div No. 605 05

Room No. D1206
SUBJECT/
REFERENCE

Telephone No. 458-0160

MESSAGE

Mr. Joy Way:
This is a Confidential note sent to
you by Mr. Sagasti

Transmission authorized by FRANCISCO SAGASTI

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

Washington, 2/11/90

Apreciado Víctor:

De acuerdo a nuestra conversación te envío unas líneas sobre el pago de los atrasos en la deuda externa peruana, actualizando algunas de las ideas expuestas en la nota anterior. Quiero destacar que, si bien el principio y la estructura de la operación de reinserción se mantiene, las cifras están todas sujetas a revisión. Por ejemplo, no tengo los datos más recientes sobre los atrasos al BID, ni el monto actual que ésta institución podría desembolsar rápidamente. Por razones que tu conoces muy bien, no quiero averiguar demasiado con mis colegas en Washington.

La conclusión general a que se llega es que las perspectivas de conseguir apoyo financiero externo en montos significativos son bastante limitadas por un par de años (por lo menos). Este es el precio que todos los peruanos tenemos que pagar por la irresponsabilidad del gobierno de Alan García. El asunto está ahora en como presentar las cosas a nuestros acreedores, como conseguir padrinos (Japón, USA, España, Canadá, etc.) que nos den préstamos puente, cofinanciamiento y apoyo político en los organismos financieros, y diseñar una estructura de endeudamiento a mediano plazo que sea viable. Las cifras adjuntas, que consideran los \$370 millones del FAR, indican lo compleja que es la situación.

Espero que puedas participar en el seminario del "El Pueblo" el 17 y 18 de noviembre. Silvia Charpentier, una amiga muy especial para mí, estará entre los expositores. Ella fue la que negoció la reestructuración de la deuda de Costa Rica y logró reducirla en \$1000 millones. Ella llega a Lima el viernes 16 y va a estar alojada en el Hotel Miraflores César. El seminario termina el domingo 18 a las 3:00 pm y te sugiero que pases algún tiempo con Silvia conversando del tema de deuda y, si se puede, tengas una reunión privada con tu principal asesorado y con ella para que les cuente su experiencia y cómo se ve la situación desde el Banco (Silvia es la Directora Alternativa por Costa Rica en el Banco Mundial).

Un gran abrazo, y nos vemos a fin de mes en la fiesta de GRADE el 30 de noviembre. Esperamos que tu asesorado pueda pasar aunque sea unos minutos con nosotros y te agradeceré sondees esta posibilidad con él.

Atentamente,



Francisco Sagasti

Reinserting Peru Into the International Financial Community:
A Plan for Clearing Arrears

Background

1. By July 1990, when a new President will be inaugurated, Peru will be approximately \$750 million in arrears to the IBRD, \$250 million in arrears to the IDB, and \$820 million in arrears to the IMF. In addition, Peru has more than \$3 billion of non-concessional bilateral debt and substantial arrears will have accumulated on this debt stock as well.

2. Clearing these arrears will have a salutary effect on the balance sheets of all multilateral lenders. For example, as of FY89, loans to Peru accounted for 1.3% of the World Bank's total loan portfolio and 25% of its loans in nonaccrual status. The Bank has already established a \$250 million loan loss reserve for Peru and expects to increase it by \$120 million per year for each of the next several years. However, if these loans could be returned to accrual status, the Bank's net income would increase by at least \$150 million per year, an amount equal to nearly 15% of actual FY89 net income and more than 10% of the projected FY93 level.

3. Any international effort to help Peru clear these arrears and reinsert the country into the international financial system will require substantial flexibility and imagination on the part of all international financial institutions. The difficulties should not be underestimated. Nevertheless, there are several good reasons for planning how to resolve Peru's financial difficulties. In the first place, both presidential candidates appear to be prepared to make significant breaks with the failed policies of the Garcia regime and adopt sensible, viable, internationally sanctioned adjustment programs. However, these can succeed only if they are endorsed by the international community and provide an avenue for reinserting the country into the international financial system. At a minimum, this will entail a concerted effort to help the new government clear its arrears with the international financial institutions so that it can return to active borrowing status with them.

4. Second, it appears that the new government is prepared to signal its intention of holding talks with all creditors -- multilateral, bilateral, and commercial banks, and suppliers -- in order to reach an accommodation with each. However, in view of the existing stock of arrears -- approximately \$1.8 billion to the multilaterals and \$2.8 billion to the commercial banks compared to annual exports of \$3.7 billion -- any attempt to restore good relations with the international financial community as a whole, will require a cooperative approach to clearing the arrears. In view of the Bank's preferred creditor status and the ensuing increase in net income that would result from eliminating its nonperforming Peruvian assets, it behooves the international financial institutions to take the lead in working with the new government. The following is the outline of a two part plan for accomplishing this goal.

IMF Arrears

5. New rules for clearing arrears to the IMF were drafted during the May 1990 Interim Committee meetings. These rules give a country an opportunity to draw additional Fund resources even though it has outstanding arrears to the Fund as well as an opportunity to refinance its arrears.

6. In order to be eligible for this special dispensation, a cutoff date is established. The country must agree to remain current on all payments to the Fund coming due after the cutoff date. This includes interest on the outstanding stock of arrears as well as interest on any claims that are not in arrears. The country would also have to be in compliance with a Fund adjustment program.

7. If the country fulfills both conditions -- interest payments and compliance with a Fund program -- for three years, its outstanding arrears will, in effect, be refinanced by the Fund and treated as any other SDR purchase. In other words, it will be subject to the same repurchase and interest rate obligations that pertain to all other Fund drawings. Resources for this refinancing operation will be raised by special assessments on countries that use Fund resources.

IDB and IBRD Arrears

8. From a conceptual point of view, it is best to think of the arrears clearing process in sequential terms, although in reality, both institutions will have to work simultaneously and cooperatively on building up the necessary investment and adjustment pipeline.

9. Arrears to the IDB, which total \$250 million can be cleared with the proceeds of a \$250 million bridge loan from bilateral creditors or, alternatively, an equivalent medium term loan from the Fondo Andino de Reservas (FAR). On the basis of its existing \$100 million pipeline of undisbursed commitments, plus its ongoing work on identifying and appraising vitally needed new economic reconstruction projects and investment programs, the IDB should have little trouble finding opportunities to rapidly disburse \$250 million to Peru. Up to \$150 million could be used to repay any bilateral bridge loan required for the arrears clearing process, leaving at least \$100 million of IDB disbursements for general imports and balance of payments support. It should be noted, however, that this operation can succeed only if the IDB is prepared to disburse against previous capital goods imports, with the appropriate documentation, and not merely against new imports. Alternatively, if arrears are cleared with proceeds from FAR, the entire \$250 million IDB disbursement could be available for economic recovery and investment.

10. In order to clear the arrears to the IBRD, both the Bank and IDB would begin joint preparation of an \$800 million jumbo SAL. Approximately \$300 million would be provided by the IDB in a first tranche release. These disbursements would be in addition to the \$250 million loan referred to in the previous paragraph. The remaining \$500 million would come from the Bank in a

second tranche that would be released soon after the first. Once again it should be noted that in order to qualify for this expedited treatment, Peru will need to compile an excellent compliance record with its shadow Fund program (which would focus on macroeconomic performance) as well as with any shadow Bank and IDB stabilization programs (which would focus on sectoral performance). In any event, getting the funds released so quickly is a potential problem that will require imagination and flexibility.

11. The \$300 million from the IDB would be combined with a \$450 million bridge loan from bilateral creditors, giving Peru exactly enough money to clear its \$750 million of arrears to the IBRD. This will enable the IBRD to release its \$500 million tranche of the jumbo loan. \$400 million will be used to repay the bridge loan, leaving Peru \$50 million for investment and economic reconstruction projects.

12. As a result of this program, Peru will have the following outstanding new debts:

\$100 million	to the providers of the first bilateral bridge loan or \$350 million from FAR;
\$250 million	to the IDB from the accelerated disbursement of project and program investment loans;
\$300 million	to the IDB from the first tranche of the jumbo IDB/IBRD SAL;
\$500 million	to the IBRD from the second disbursement of the jumbo SAL.

Thus, total new debt will be between \$1150 million and \$1400 million.

13. Excluding the bridge/FAR loan, Peru will owe approximately \$80 million per year of interest on these new loans. In addition, it will have to remain current on its Pre-Garcia loans to the IBRD and IDB. According to the most recent World Debt Tables, this stock of debt amounts to approximately \$1.7 billion. Interest on this debt stock will be approximately \$135 million, assuming an interest rate of 8%. Therefore, total annual interest payments to the multilaterals, not counting the IMF, will be somewhere in the vicinity of \$200 million. This raises several additional, follow-up issues:

- Will future disbursements from the Bank and the IDB be sufficient to reduce these net transfers to manageable proportions?
- How much headroom for additional disbursements exists in the IDB and IBRD, given the limitations imposed by their current portfolio and risk management guidelines?
- If additional IFI disbursements are not feasible, could fresh rounds of bilateral assistance help Peru finance part of its interest payments to the multilaterals? If so, Peru will have found a de facto way to refinance its interest payments without requiring the Bank to reschedule its debts.

Bilateral Debt

14. Peru has \$3 billion of nonconcessional bilateral debt. In 1988, interest payments on this debt stock were \$114 million. On previous occasions, several US Members of Congress have suggested that the US should accept local currency interest payments for at least part of its bilateral debt. The Japanese are also considering a similar proposal. Although most of these proposals have been put forward in the context of Eastern European debt, there is no technical reason why they could not apply to Peru as well. The local currency funds would be retained in Peru where they would be available for a variety of uses including a social emergency fund, loans to micro enterprises, etc. At a minimum, perhaps only the interest payments on the remaining \$100 million bridge loan could be serviced in local currency. Even this modest step would alleviate both the domestic resource mobilization and external payments constraints simultaneously.

15. The linchpin of this entire plan is the willingness of bilateral creditors to extend bridge loans, even though they may have outstanding overdue claims on Peru. It should be noted, therefore, that Paris Club rules do not bar new disbursements, despite large Paris Club arrears. The rules merely specify that all reschedulings must be done in concert. In other words, no unilateral reschedulings are permitted. However, new lending is not bound by the same "all for one and one for all" mentality. US law, however, (the Brooke-Alexander amendment to the foreign assistance bill) forbids new lending to any country that is more than one year behind in its debt service payments on US government loans, unless the President certifies that additional loan commitments are in the US national interest.

Commercial Bank Debt

16. At this preliminary stage, it may be somewhat premature to focus too much time and attention on commercial bank debt. It would appear, however, that Peru's best option is to repurchase its debt at current secondary market prices. At the same time, enhanced new loans could be solicited from the commercial banks. Enhancements could come either from the ECO/EXCEL program or from offshore collateral accounts funded with the proceeds of copper or other exports. Either option will bump up against the constraints imposed by the Bank's current operating guidelines. (However, the prohibition against providing ECO guarantees to rescheduling countries may be lifted in the near future.) In addition, a variety of Latin American and Eastern European countries have been concluding innovative deals with the private financial markets on the basis of security packages consisting of offshore escrow accounts. These mechanisms may hold the key to unlocking new flows of private international finance after the current debt overhang is eliminated.

F.S./ A. W.
5/25/90

I. FAR Issues

1. The original proposal recommended that a \$250 million bridge loan from bilateral creditors be used to clear the \$250 million of arrears to the IDB. This would be followed by a \$250 million IDB disbursement to Peru, of which \$150 million would be used to retire part of the bridge loan, leaving Peru with \$100 million of new bilateral debt, \$250 million of IDB debt, and \$100 million of available cash. Peru's net debt (gross debt minus cash and repayments) at the end of the transaction would rise by \$250 million, since the \$100 million of additional reserves would offset the \$100 million of unpaid bilateral debt.
2. The \$370 million medium term loan commitment from FAR changes the calculations significantly. First and foremost, Peru could replace the short term bridge finance with FAR's medium term funds. Second, since IDB disbursements would not be used to retire the short term bridge loan, the government would have greater cash reserves and a larger, longer term debt structure. Specifically, if a portion of the FAR funds were used to clear the IDB arrears, Peru would have \$120 million of cash left over from FAR and \$250 million of cash from the IDB, for a total increase in reserves of \$370 million. At the same time, however, it would have a \$370 million debt to FAR and a \$250 million debt to the IDB. Peru's net debt immediately after the transaction would still be \$250 million (since the available cash would offset the FAR debt on the country's balance sheet), but it would have larger cash reserves and a larger gross debt than in the previous case.
3. If maximizing the country's cash reserves is a key consideration, using the FAR funds for arrears clearance purposes would seem to be a worthwhile endeavor. At the same time, however, it should be noted that under either option, the additional reserves will presumably be spent on essential imports for investment and recovery. After the cash is spent, Peru's net debt would rise to \$350 million in the first case and \$620 million in the second case. Is the additional \$270 million of expenditures worth the additional \$270 million of new debt and its associated interest payments? This is a key question which the authorities have to address.
4. As a result of this revised program (and assuming that the portion of the discussion dealing with the IBRD/IDB jumbo SAL remains unchanged), Peru will have the following outstanding new debts

\$370 million	to FAR;
\$250 million	to the IDB from the accelerated disbursement of project and program investment loans;
\$300 million	to the IDB from the first tranche of the jumbo IDB/World Bank SAL;
\$500 million	to the World Bank from the second disbursement of the jumbo SAL.

Thus, total new debt resulting from the arrears clearing operation will be \$1520 million. Annual interest payments on this new debt will be approximately \$120 million, assuming an 8% interest rate. In addition, Peru

would be expected to remain up to date on the interest payments on the pre-Garcia stock of bilateral and multilateral official debt. According to the World Bank's 1989 World Debt Tables, this will add an additional \$600 million per year to Peru's required interest payments. This could be reduced somewhat by applying Toronto terms to the bilateral, non-concessional portion of the official debt. However, since this is a small portion of the total, the scope for relief under the Toronto terms would appear to be limited. In addition, the cash flow savings from Toronto terms are slow to appear. Consequently, the amount of immediate relief would appear to be rather limited.

II. IDA Issues

5. Peru has recently been declared IDA eligible. However, the practical impact of this designation would appear to be limited. As matters now stand, SDR 300 million of IDA funds remain unallocated for the entire FY92-FY94 period and are available for use by newly eligible IDA borrowers. However, the list of newly eligible countries includes Egypt (which has recently asked for an IDA allocation of more than SDR 500 million), Nicaragua, Guatemala, Honduras, and El Salvador. The share of funds that will actually end up going to Peru would most likely be quite small. Consequently, the IBRD jumbo SAL and most other IBRD loans will most likely be disbursed on regular IBRD terms.

6. Two fairly new IDA programs could be of special interest to the government, but once again, it is unlikely that sufficient funds could be made available to Peru under the auspices of these programs. First, IDA recently established a special \$100 million fund to finance Brady Plan debt reduction operations with the commercial banks. As an IDA eligible country, Peru could use these funds. However, it would first have to negotiate a comprehensive debt reduction operation with its commercial bank creditors. In addition, since Peru would need at least \$250 million to retire its entire medium and long term commercial bank debt at a 95% discount, the amount of actual debt reduction that could be financed with these special IDA funds would be quite limited. The rest of the debt reduction operation would have to be financed either with bilateral grants, if any are available, or by using high cost IBRD and IMF funds.

7. IDA also has a special facility to help newly eligible IDA countries service their existing IBRD loans. Unfortunately, I am not familiar with the rules governing access to these funds, but will have the answers available in a follow up note early next week.

8. The conclusion would seem to be that Peru's designation as "IDA eligible" may not confer any immediate financial benefits. If the government wants to alter this assessment, it will need to mount a concerted political and diplomatic strategy around the question of access to IDA funds.

- Banco mundial
- Evitar triunfalismo
- Ukanda / -Tapan

- JCHutodad / Tesoro
- ZMB ←
- Cow Valley

• Ensayo para ver como
 esto el agua, que
 proceso de negociación

• Examen riguroso

• \$1 500 millones de
 Egipto (swap)

• Banco B central
 • Egypt / World

By way / nature / source:

27/9/90

~~By way~~

- Things are going well in economic policy
- Work with multilateral institutions.

Talks with:

to the Group
loan

France, Spain, Italy, Germany, Canada, Japan

(act for line, except Japan) but they are under way with them: Okita → only of the US acts for their help)

- Spain & Japan as co-borrowers for the bridge loan → Char Pw
- IDB (Iglesias is ready to take an active part) ^{support} _{group}
- All of this subject to an adjustment program (But this is now under way)

• IMF: worried about wages; Salomon → fiscal ~~deficit~~ deficit → primary surplus.

• Hussein: (talked with Okita in Lima, Japan is ready to purchase, but American not ok); (also talked to Okunaka); TO early to specify conditions.

• Today a meeting with Mufson → interview to But Drug issue: (no crop substitution program) to be decided

MTF

• Cyprus → lunch with Senator for Alaska McGinnis (Mufson)

• FAR: 370 million (sup to)

• Africa: 50 million

• Venezuela: 250 million

• Canada (Wilson)

good receipts → out in the aspect

low

to confer the group.