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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 92/68

10:00 a.m., May 29, 1992

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
	A. Raza, Temporary
	Chen M., Temporary
	G. C. Noonan
	J. Jamnik, Temporary
T. C. Dawson	Q. M. Krosby
	M. E. Hansen, Temporary
	J. Prader
E. A. Evans	R. L. Knight
R. Filosa	J. Papadakis
M. Finaish	M. B. Chatah, Temporary
I. Fridriksson	A. Gronn, Temporary
H. Fukui	N. Tabata
B. Goos	B. Esdar
	T. Sirivedhin
A. Kafka	J. C. Jaramillo
J.-P. Landau	I. Martel
	O. Kabbaj
	S. Raoui, Temporary
L. B. Monyake	
	P. Wright
G. A. Posthumus	
	B. A. Sarr, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

<u>Also Present</u>
IBRD: T. A. Hoopengardner, Europe and Central Asia Regional Office; J. D. Shilling, Development Policy Group, Office of the Vice President. African Department: C. Brachet, P. Ewenczyk. European I Department: M. Russo, Director; M. C. Deppler, Deputy Director; G. Belanger, E. V. Clifton, L. V. Mendonca, A. Singh. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; J. J. Clark, Jr., C. V. A. Collyns, R. A. Feldman, S. Ishii, G. R. Kincaid, R. K. Rennhack, D. O. Robinson, B. E. Rourke. External Relations Department: V. R. Khanna. Fiscal Affairs Department: E. F. Offerdal. Legal Department: R. H. Munzberg, Deputy General Counsel, J. L. Hagan, Jr., A. O. Liuksila. Research Department: R. D. Haas, M. S. Khan, M. D. Knight. Secretary's Department: A. Jbili. Treasurer's Department: S. I. Fawzi, C. A. Hatch, A. W. Lake. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: L. Dicks-Mireaux, J. M. Jones, J.-C. Obame, Y. Patel, A. Quirós, A. M. Tanase. Assistants to Executive Directors: J. R. N. Almeida, D. A. Barr, J. H. Brits, J. A. Costa, M. Da Costa, N. A. Espenilla, Jr., S. K. Fayyad, A. Giustiniani, S. Gurumurthi, O. A. Himani, K. Ishikura, K. Langdon, W. Laux, M. Mrakovcic, L. F. Ochoa, R. K. W. Powell, L. Rodríguez, P. L. Rubianes, D. Sparkes, Tin Win, J. W. van der Kaaij.

1. DEBT AND DEBT-SERVICE REDUCTION - MODALITIES OF FUND SUPPORT

The Executive Directors considered staff papers on modalities of Fund support for debt and debt-service reduction (Section IV of EBS/92/52, 3/17/92; and Sup. 2, 5/11/92).

Mr. Végh made the following statement:

While the debt strategy for middle-income countries has contributed to the return to external viability of several debtor countries implementing comprehensive adjustment programs and to a reduction of the underlying threat to the international financial system, it remains critical that the cooperative effort not slacken, as a considerable number of countries continue to have debt difficulties. Adequate and timely disposition of Fund resources remains essential to preserve the effectiveness of the overall approach.

The question to be asked is whether an artificial resource constraint emanating from the segmentation of enhancement resources, while seemingly consistent with the objective of debt reduction, actually improves the prospects for medium-term viability. In our view, the additional uncertainty regarding a government's ability to secure the necessary counterpart resources or the associated possibility of a further delay in implementation of a market-based debt accord--after an already lengthy process of negotiation--serves only to deteriorate confidence that the financial credibility of the government is being restored and to retard private capital flows even when the adjustment component of the debtor's program is performing satisfactorily.

The evolving nature of debt reduction packages and acceptance of the notion of price equivalence between debt and debt-service reduction options call for flexibility in the application of the guidelines. As debt-service reduction instruments deal explicitly with two of the major sources of transfer risk--which precipitated the debt crisis--namely, high nominal interest rates, and unpredictability associated with rate volatility, the correct signal to the markets should be one of funding support when the debt-service reduction option is in fact exercised. Consequently, allowing for fungibility of augmentation resources, when cost-effectiveness and the other requirements for their use under the guidelines have been met, is the best assurance that the objectives of a comprehensive work-out are being met with the widest possible participation among creditor banks.

The exclusion under the present guidelines of Fund support to finance the collateralization of principal in reduced interest par bond exchanges affects the freedom of choice between economically equivalent debt and debt-service reduction instruments and the volume of access to resources available for comprehensive market-based debt reduction operations. This latter aspect becomes particularly noticeable now that interest support has become less expensive relative to principal support in light of lower short-term interest rates in dollars.

In this context, the staff recommendation to allow for the use of augmentation resources to collateralize principal in par bond exchanges, without modifying the existence segmentation, is considered a minimal recognition of the present constraints. A broader scope of application of available resources is needed to accommodate cost-effective operations under negotiation and to catalyze other resources for re-establishing external viability.

I welcome the supplemental information on the subject circulated by the staff in EBS/92/52, Supplement 2, which indicates that the constraints of the present guidelines are in the near term relevant for at least two members, posing an artificial resource constraint when the other postulates of the debt strategy have been observed. In my view, ad hoc interpretations of the present guidelines to accommodate the manifest need for their flexible application, even if legally justified, entail a potentially serious departure from the principle of uniformity of treatment. From this angle, it would also be advisable to explicitly broaden the scope of the present guidelines and to amend the decision on early repurchase expectations accordingly.

Finally, with respect to the Argentine negotiations with the Bank's Advisory Committee, as we have informed the Board, an agreement in principle was reached on April 7, 1992 on a comprehensive restructuring of medium- and long-term commercial bank debt, including past interest. The ongoing discussions are proceeding at the technical level with a view to reaching agreement on a final term sheet for a financial package in June, and receiving, as estimated by the Advisory Committee's timetable, banks' commitments on preferred menu options, consisting mainly of principal collateralized interest-reduction par bonds, collateralized discount bonds, and past due interest bonds, by next July at the earliest.

Mr. Evans made the following statement:

We strongly support Management's proposal to allow the use of augmented resources to collateralize the principal of reduced interest bonds. Even if it is only a partial step, it is nevertheless a positive one towards remedying long-standing gaps in the Fund guidelines. It will also give operational substance to a broadly held view in the Board that undue constraints on reasonable agreements in individual cases should be avoided.

The ideal approach, one which we have consistently advocated, would be to provide for full flexibility in use of resources across alternative instruments once the overall debt package has been judged by the Board to be a beneficial operation. The logic is straightforward. It makes little sense to distinguish between set-aside and augmented resources as to which elements of essentially equivalent instruments in a menu of options may or may not be financed. Such flexibility would not in any way undermine the Fund's discretion on the size of its exposure to the operation, because it would retain the right to determine in each individual case the overall size of access to set-asides and augmented resources. On the other hand, adherence to rules that have the effect of segmenting uses simply adds a layer of complication and uncertainty that undermines the principle of assisting debtors in the context of the Brady initiative. The problem is not simply one of constraining the scope of agreements but also a more subtle one of hindering earlier agreement because of the need to first align funding resources with market preferences.

In the past, the Board has acknowledged these arguments but has stopped short of amending the guidelines, preferring to rely on the application of flexibility in individual cases. The present documents, however, disclose for the first time that the needed flexibility does not exist. The Board does not have the scope to apply the guidelines flexibly in individual cases. The only flexibility available to the Board, in considering individual cases, is to amend the guidelines. I think I can say with some confidence that this is not the concept of flexibility that the Board had in mind. It is simply wrong--it is bad policymaking--to place an individual country in the invidious position of having to enter into complex debt negotiations on the basis of its own assessment of whether or not the Board will amend its policy guidelines. This is not uniform treatment of members.

I hope that the present limited proposal will garner the broad support it deserves but also that this decision will pave the way to the removal of segmentation at the earliest opportunity.

Mr. Landau made the following statement:

Three main features characterize the relevant developments since our last discussion. First, significant moves have been made on official debt. Second, overall progress on commercial debt restructuring has been slow. Third, access to spontaneous capital flows has risen in a significant manner for a number of borrowers. Also noticeable is the growing concentration of risk on public creditors, with commercial banks extending loans to an increasingly small number of countries.

I will now reflect successively on some of those issues. Last December, the official creditors at the Paris Club reached an agreement that met expectations expressed by the international financial community. This agreement allows, for the low-income countries, debt relief substantially more important than in the Toronto treatment--50 percent reduction in net present-value terms of debt-service payments consolidated on nonofficial development assistance debts. This new treatment has been tailored to meet the needs of the poorest and most indebted countries. Several nations in Africa and Latin America have already benefitted from these terms. This new treatment is a reflection of the international solidarity that is necessary to face the problems experienced by many debtor countries, especially in sub-Saharan Africa.

Two points are worth mentioning: the possibility offered on a bilateral basis, to the creditors that wish to do so, to employ debt conversions on the same conditions as those already applied to the lower middle-income countries; and the possibility to treat, at the end of a probationary period of three years, the stock of debt of the countries concerned. My authorities fervently hope that all Paris Club creditors will henceforth select and implement the most concessional options under this new treatment.

Besides, there is a continued need for creditors to examine the situation of the lower middle-income countries engaged in ambitious economic adjustment policies under the aegis of the Fund. If any generalization of public debt reduction measures should be avoided, it is certainly necessary to provide those countries that undertake significant efforts with the appropriate solutions, regardless of the category, classification, and limits already established.

In the context of increasing efforts by public creditors, the comparability of treatment between public creditors and private creditors is increasingly essential. As examples have shown in the recent past, private creditors stand to gain heavily--in terms of an increase in the secondary market prices--from the debt reductions implemented by official creditors. Parallel efforts on their part are all the more necessary because public creditors make efforts outside consolidations in the Paris Club, by granting new guaranteed commercial credit, fiscal development aid, and participation in multilateral financing institutions.

On private financing of developing countries, we are impressed with the success of some countries in regaining access to capital markets. This validates the whole strategy of debt reduction together with strong structural adjustment. However, new capital inflows are provided mainly through the bond market, while bank financing remains quasi-nonexistent. In this context, the staff raises the issue of the prudential standards and provisioning rules implemented in developed countries. Let me just say that my authorities share the view that the continuing improvement of the financial situation of some developing countries should probably allow for a better differentiation of the level of provisioning required from the banks, as well as some greater flexibility in reviewing past provisioning requirements. They are working on those improvements.

Regarding commercial debt and debt-service reduction operations, we fully agree with the analysis of the situation presented in the staff report. I have only one question. Last year, the emphasis was put on the necessity to develop and encourage phased operations--as opposed to one-shot big packages--for implementing debt and debt-service reduction. In this year's report, the matter is dealt with very briefly and it seems that the evolution of the situation has not met the expectations of the staff. Could we have some comments in this regard? Why has there been some disappointment?

I will now comment on the modalities of Fund intervention and the proposal for a modification of our guidelines. We recognize the necessity of providing enhancements for collateralizing the principal of reduced interest par bonds and, therefore, we can support the thrust of the staff's proposal.

However, as this is the first time that the Board is considering a formal change in the guidelines, some further reflections might be warranted. I would point to some paradoxes of the present situation stemming in particular from the rigidity in the segmentation of our resources.

First, the staff proposes that augmentation resources should be used to fund collateralization of principal of reduced interest par bonds. The staff recognizes that there is no overriding reason for doing so. The main reason is that those resources are more likely to be available than set-asides. I would point to the fact that the original rationale for segmentation was the concern that, on the contrary, debt-service reduction operations would be privileged, to the detriment of debt stock reduction, so that some limit on the resources allocated to interest reduction was needed. Experience has proved this assumption wrong, and the least we can say today is that the rationale for segmentation has thus mainly disappeared.

Second, as past experience on agreed operations has proved, segmentation has been detrimental both for the borrowers--as in the case of the first package for the Philippines, in which the buy-back had to be limited--and for the Fund, as in the case of

Venezuela, in which we had to commit a greater amount of resources than if they had been totally fungible.

Third, we recognized ourselves last year that some flexibility in the use of augmentations and set-aside resources might be needed. We did not go further because we did not want, at that stage, to formally amend the guidelines. This reason is of course no longer valid.

In fact, in the light of past experience, the interest of the Fund would be better protected if, rather than allocating our enhancements between augmentation and set-aside on the basis of the nature of the instrument, other approaches were to be used.

A good procedure would be for this Board first to use the set-asides accumulated under the program, at the date of the operation. Then a choice would have to be made, independently from the instruments, between using further accelerated set-asides or augmentation resources. This choice should be made on a case-by-case basis. The criteria would be, on the one hand, the level of access already reached by the borrower, which would determine whether additional augmentation resources would be appropriate, and the past track record on the program, which would influence the decision to accelerate future set-asides. By doing so, the Board would not endanger the financial interests of this institution, but, on the contrary, ensure better protection.

Two points can be considered. First, if the totality of resources coming from augmentation and set-asides had to be used, the question of whether they were segmented or not is irrelevant for the exposure of our institution. Money is fungible and so should the enhancements be in this case. Second, if, on the other hand, the packages require only partial use of the potential resources available under our guidelines, it seems clear to me that our interests would be better protected by the approach I outlined rather than by a rigid allocation under the present guidelines.

In sum, we can support the extension of the enhancements provided by our institution for collateralization of principal of reduced interest par bonds. We would like, on this occasion, the segmentation of our resources to be reconsidered and the guidelines accordingly amended. Finally, if the present system were to be maintained, it would seem to us preferable to use set-aside--rather than augmentation--resources for enhancing those par bonds. This would be, it seems to me, more compatible with our present practices and would limit in a better manner a potential increase in our exports.

Mr. Fukui made the following statement:

I support the staff's proposal that the guidelines for Fund support of debt operations be modified to allow use of augmentation resources to collateralize principal of reduced interest par bonds. For emphasis and clarification of our position, I would like to make three points.

First, as the staff rightly noted, Fund support under the present guidelines is likely to impose artificial constraints and biases among economically equivalent debt and debt-service reduction instruments. This is because of the lack of availability of Fund resources for principal collateralization of par bonds. In my opinion, it is particularly problematic that this would lead to greater use of other options like cash buy-backs and encourage exits of bank creditors. Therefore, we share the staff's view to allow some kind of Fund resource to finance principal collateralization of par bonds.

Second, for this purpose, I endorse the use of augmentation resources--in other words, we endorse maintaining the segmentation--not set-aside resources, mainly for the same reason given by the staff, namely, that the deviation from the guidelines will be less in the case of augmentation resources than set-asides. Furthermore, I am inclined to think that we can send a more positive signal of support for debt operations by allowing the additional Fund resources to be used for this purpose.

Third, as I mentioned, this chair is not inclined to support the proposed increase in fungibility of Fund resources. The existing segmentation should be maintained, because we are seriously concerned that, if fungibility were approved, more augmentation resources might be used for cash buy-backs and discount bond swaps and might encourage exits of private banks by virtue of the increased burden on the international financial institutions, something we cannot support. For that reason, we are inclined to maintain the segmentation system in this operation.

With these comments, I support the staff's proposal.

Mr. Dawson made the following statement:

I am particularly disappointed by the comments of a couple of speakers, who have given the impression that the debt strategy has been a failure because of shortcomings that are under discussion today; many of the cases that have been mentioned today are in my view substantial successes.

Nevertheless, I think that the staff presents an issue that does need to be addressed. After a fashion, the staff is basically on the right track. However, we have some concerns about the implications of the proposed approach, which the Board should be aware of and take into account as it considers individual country cases that are coming along that we know about, as well as implications along the lines of Mr. Fukui's comments on the existing segmentation policy; not surprisingly, I agree with Mr. Fukui's points on that policy, as the current guidelines do not permit using the resources of international financial institutions for these sorts of principal collateralized debt instruments.

I would stress there that has not been as yet any compelling need to relax the guidelines. I note a reference in the original paper, and also this morning, to the particular country cases of the Philippines and Argentina. My understanding is that at this point one could conceive the Philippine agreement as being quite likely not to require this sort of support; but in the Argentine case it is quite clear that the situation is different.

To date, of course, there have been adequate resources other than those of the international financial institutions with which to support these sorts of instruments, and we think that the current guidelines have worked, although there is admittedly an artificial nature to them, as most constraints are artificial. The guidelines have had a positive impact of encouraging not only an expanded menu, but also to some extent a balanced selection from the menu, including in effect requiring a significant commitment of resources by the debtors that have resources available, while, as Mr. Landau noted, limiting the exposure of international financial institutions. I was pleased to note that he concluded his remarks by expressing some concern about the exposure in these cases of the international financial institutions.

The staff argument that "the exclusion of Fund support for such instruments could impose artificial constraints and biases among economically equivalent debt and debt-service reduction instruments, thereby undermining the implementation of an appropriate financing package" is one that I think we have some sympathy for in principle. But as we get into the actual case, we are concerned that we would be opening the door to a situation in which we might wind up being asked to support debt and debt-service reduction instruments that are not economically equivalent, a point to which I will return.

We do believe that an amendment of the guidelines to permit augmentation resources to be used to collateralize par bonds is appropriate, provided that, first, such flexibility does not work to the disadvantage of debt reduction operations, such as discount bonds that we have been supporting. In addition, we do think that the flexibility in the case of the Argentine agreement that is pending is going to be necessary, although I do not think that it will prove sufficient, to complete the bank deals currently under discussion. There is no doubt that the banks view par bonds as an integral part of the menus that they are looking at, and we do accept that par bonds deserve equivalent support, but in the context of a balanced package.

However, the proposed amendment could be viewed as being too open-ended, and in the case of Argentina--the first case in which it is likely to be applied, it is too open-ended. It is clear, as Mr. Végh noted, that negotiations between the banks and Argentina are now at a fairly critical stage. Notwithstanding the comments both in the staff paper as well as, for example, Mr. Evans's comment that the Board has the right to come back once a package has been developed and then decide the nature of Fund support for it, I fear--and this is a major tactical concern--that we have been placed in a situation in the case of Argentina in which the banks have already not only anticipated approval of the action that is recommended today but, in our view, as a result of our extensive contacts with the banks, also are expecting us to change the set-aside guidelines; that is something we need to avoid, because it puts the Board in the awkward position of basically endorsing an agreement that the banks and the authorities have already negotiated, an outcome that is not consistent with the role of the Fund. I think that the banks do now view augmentation resources and set-asides as a single pool of money; I know there is a difference of opinion in the Board on that issue, but the banks have anticipated a decision that we have not yet made.

In the case of Argentina, there is a strong indication that the par bond has been mispriced and overenhanced: our understanding is that 80 percent or more of the deal is going to be in the form of the par bond instrument. In my view, that is not a balanced package by any definition. A logical argument can be made for reopening the banks' deal with Argentina. The banks, however--and perhaps the authorities as well--feel that that cannot be done. Therefore, the Fund is expected to respond to the banks and Argentina--a situation that is either backwards, or upside down, or perhaps both. Therefore, as we look at the staff's proposal, we need to see how we can keep this from becoming what amounts to a stampede on the Fund. I would hope that we and the countries concerned would learn in the future to seek a more balanced approach; even if one winds up having what I call a corner solution, it could done at a somewhat lower price.

What would suggest that, as the Board looks to amend the guidelines--and we can support an amendment--we should agree that the augmentation resources should be used on a case-by-case basis for these sorts of operations on the basis of the following presumptions: first, obviously there must be a demonstrated need based on actual bank choices, a judgment that the staff regularly makes; second, the operations should represent a cost-effective and efficient use of Fund resources; third, the options in the package should be balanced so as to not disadvantage debt reduction operations, and this would mean in particular that the par and discount bonds, as well as other instruments, are economically equivalent (I think that there is a serious question about that in the present approach); and fourth, the debtor country itself should have contributed adequate resources of its own in support of the package.

Conceptually, my proposal could be approached in the following manner: we support both the staff recommendation and Mr. Fukui's comments that set-aside resources continue to be used only to support debt reduction operations, such as discount bonds and buy-backs, as in the current guidelines; we look to augmentation resources to be used first to meet the interest support requirements of the debt deal that are required to complete discount bonds or enhancements and, therefore, par bonds, and interest support for any debt-service reduction instruments; enhancements available from the debtor and bilateral resources would be used to collateralize the par bonds, which is the present approach anticipated in the Argentine case, and as I understand it there are Japanese resources available for that purpose if there is a shortfall in enhancements to collateralize the par bonds; the remaining augmentation resources, if any, would then be used to collateralize the par bonds.

It is certainly true that the recent fall in interest rates is one of the reasons why we are having this sort of excess of augmentation resources and, frankly speaking, one of the reasons why we support this sort of change--because the money in that sense is available. We should recognize that if there is a shortfall in enhancements to collateralize par bonds after this sort of approach has been taken, any additional resources would have to come from resources other than those of the international financial institutions--either additional resources from the debtor, from other bilateral resources, or from the banks themselves. We, like Mr. Fukui, would not support any further fungibility for that purpose or any increase in the extent of support by international financial institutions.

As Mr. Evans noted, the Fund, under his approach, would not be at risk, as it can always decide the amount of support that it wishes to give to a deal. That is an appealing argument theoretically, but not in reality, because the case we have been presented with now is one in which we are, in a sense, being presented with an expectation, on the part certainly of the banks

> and I think on the part of the authorities, that the funds are there. So I think that we have been put in a very reactive position--reactive at best, because my contacts with the banking community indicate that the banks have presumed this decision had already been made; in fact, the banks were surprised to find that we were having a meeting to discuss the matter.

Mr. Landau considered that Mr. Dawson's point that the commercial banks were anticipating that the Fund would adjust its guidelines in response to the agreement between the banks and the Argentine authorities was well taken. That fact demonstrated the excessive precision and rigidity of the guidelines. Therefore, the Board should consider how the Fund could better protect itself. He had no definite proposal to make, but the idea that the Board should introduce additional precision and greater rigidity into the guidelines certainly would not provide greater protection for the Fund.

The Chairman said that he did not fully agree with Mr. Landau. In the long history of the debt strategy, the banks had on several occasions played the kind of game that had been described during the present discussion, in which the banks tried to take for granted a certain attitude of the Executive Board. The banks had recognized that they were playing a risky game, as the Fund did not always do what they expected it to do.

Mr. Dawson remarked that the Fund had not yet had to change the guidelines, although a change was necessary at the present stage. The Fund had never kowtowed to the banks. He wondered how the Fund could proceed with Mr. Landau's approach without making its decisions on the basis of a fait accompli, as seemed to be the case with respect to Argentina, as Mr. Landau had noted.

Mr. Landau commented that in at least one case, that of Venezuela, there had been a widespread feeling that the Board had gone somewhat further than it should have to accommodate the banks. That conclusion applied to not only the debt reduction operation but also the whole package for Venezuela. Owing to the complexity of that case, the Fund's exposure in Argentina was greater than everyone had thought would be necessary. It might be best to keep some uncertainty about how the Board would react to the demand for more enhancements rather than maintain rigid guidelines.

Unlike Mr. Dawson and Mr. Fukui, he did not support maintaining the current segmentation, Mr. Landau said. He agreed with Mr. Fukui that the banks should not be encouraged to exit from debt agreements, and that the resources allocated to buy-backs should be limited, which was the reason for having segmentation. Mr. Dawson had mentioned that he was worried about the Argentine package, because it provided for excessive interest reduction compared with buy-backs. That argument showed that judgment on segmentation was not based on a uniform approach to the issue, and that judgment on a case-by-case basis might be appropriate.

It was for that reason, Mr. Landau went on, that he would object to the additional precision that Mr. Dawson would give to the guidelines. In his view, Mr. Dawson's approach would appear to be too unfavorable to interest rate reduction operations as compared to debt and debt-service reduction operations. While the two kinds of operations might be economically equivalent in actual terms, interest rate reduction was, in terms of cash flow for the immediate future, sometimes a much better option than debt stock reduction, and consideration of liquidity apart from the consideration of economic efficiency might be very important for some borrowing countries. Therefore, any step that would further discourage, or seem to discourage, interest rate reduction operations would be detrimental.

Mr. Evans noted that Mr. Dawson had made the point that, as he himself had remarked from a different vantage point, the participants in the debt agreement on Argentina had anticipated what the Board's decision would be. In his view, the Fund had put Argentina in that position--and had done so wrongly. Moreover, the Fund had done so in saying that it would apply flexibility, even though at present the Board was being told after the event that it did not actually have the flexibility to apply other than by changing the guidelines. That fact meant that the Chairman's statement in his summing up on April 5, 1991 that "we monitor developments carefully with a view to avoiding undue constraints on reasonable agreements in individual cases, bearing in mind the call for flexibility made with particularly broad support today," should be withdrawn if the Board were to decide at the present meeting not to amend the guidelines, in which event the Board would have to indicate that it could not apply the guidelines flexibly.

Mr. Dawson said that Mr. Evans's position assumed that the current guidelines provided for undue constraint on reasonable debt agreements. The Board would naturally be disappointed with an approach under which the banks assumed that the Board would have already taken a particular action that the banks favored. The views of Mr. Landau, Mr. Evans, and others on the issue of fungibility and segmentation were well known. The guidelines had not yet been changed, and some parties had assumed that they would be amended. His chair supported an amendment to the guidelines; he was reacting to the experience that suggested that some kind of adaptation was necessary.

Mr. Evans commented that it was ironic that the Board itself should put countries in a position of being obliged to anticipate what the Board's decision on support for debt reduction would be; that was simply poor policymaking. Moreover, it was worrying to have a legal opinion after the event that held that the Board did not have the flexibility it had for some time assumed that it had possessed.

Mr. Filosa recalled that had consistently noted the usefulness of interest reduction from a cash-flow point of view. But the real question at hand was the one the Chairman had mentioned, namely, the efforts by banks to play games with debt packages. The issue that needed to be resolved was whether or not the banks were encouraged to play games because the guidelines imposed an undue limitation from an economic point; in his view, the guidelines did so. The best way to avoid the banks playing games was to bring the guidelines more in line with the economic results achieved in the Fund.

The second point that should be discussed was the reason for denying support through augmentation for a country that had a debt agreement that was deemed to be adequate, Mr. Filosa said. He doubted whether the current guidelines were consistent with the debt agreements that had a sound economic foundation. There was nothing to suggest that the reason why the banks were playing games was because the guidelines were correct and that the banks' attitude was therefore appropriate.

Mr. Dawson said that it was important to consider whether the banks were playing games because of the guidelines or in disregard of them. Apparently the share of par bonds in the agreement for Argentina was about 85 percent. Mr. Landau and Mr. Filosa apparently felt that, in theory, removal of the constraints on the choice of instruments would result in broadly even use of the instruments. In fact, the choices in the case of Argentina were not economically equivalent and, therefore, not particularly efficient either.

Mr. Végh noted that the approach taken by the Argentine Government to the debt package was based on standard methodology--it was not different from other cases. As to the creditors' preference of instruments, it was based on their own conclusions about conditions in the market. Perhaps the term "corner solution" was appropriate, as Mr. Dawson had suggested. There was a preference among the authorities for debt-service reduction, which, as Mr. Landau had argued, was a much better solution for creditors and debtors than a reduction of the stock of debt.

Mr. Prader made the following statement:

> During our discussion of the review of Argentina's stand-by arrangement on March 31, Mr. de Groote noted that it could be useful to consider the possibility for the Fund to provide financial resources to collateralize the principal of reduced interest rate bonds. This menu option now seems to have become so attractive to the commercial banks, in the context of both Argentina and the Philippines, that financing problems could arise unless the multilateral institutions acquire the ability to help support this kind of debt operation.
>
> Let me briefly state four reasons why I think we should indeed modify the guidelines for Fund support of debt operations to permit the Fund to help finance the collateralization of the principal of reduced interest par bonds. First, we need to take care that the Fund's involvement in the debt strategy is not impaired by a refusal to adjust our guidelines to new market developments or preferences in the debt area. Such a refusal would be especially unwise at a time when the so-called debt

strategy is paying off. Second, it would seem very strange on the part of the Fund, or the multilaterals in general, to insist rigidly implementing the earlier strategy at a time when bilateral official and private creditors are displaying greater inventiveness in dealing with the debt problem in several countries.

Third, although the staff is correct in noting that we advocate a case-by-case approach in the debt strategy, this must still be done within a general framework in order to avoid ad hoc solutions endangering the principle of uniformity of treatment. It is, indeed, this very principle itself that now requires us to modify our general guidelines slightly to permit the case-by-case approach to be pursued under optimal conditions. And fourth, refusing to modify the guidelines would make it appear that the Fund favors certain classes of debt reduction techniques over others. A similar argument was used in the debate on the segmentation of Fund resources for debt and debt-service reduction, but as the staff pertinently notes, the issue before us today involves no change in the agreed segmentation, and we should therefore carefully avoid the trap of re-opening the segmentation debate.

To conclude, I have advanced four arguments in favor of adjusting our guidelines and, consequently, our decision on early repurchase expectations as well. As to whether this adjustment should be accomplished by modifying the use specification on set-asides or the use specification on augmentation resources, I see good reason to favor the latter approach: the requirement for demonstrating that the support will be decisive before augmentation resources can be made available will provide a kind of balance to the broadening of the ways in which augmented access can be used. This will help ensure that requests for augmentation will be no larger than needed and will protect the Fund from the appearance of a bias opposite to that mentioned above.

Mr. Jamnik made the following statement:

Let me say at the outset that I have no problem supporting the recommendation to modify the guidelines for Fund support of debt operations to allow use of resources to collateralize principal of reduced interest par bonds. Indeed, the exclusion of Fund support for this type of operation could needlessly reduce the benefits obtained by a member country from a given level of available Fund resources.

As I recall, the original reason for excluding use of resources for such a purpose was the concern that, left to their own devices, commercial banks would invariably choose interest reduction over debt stock reduction. At the time, it was felt by some that this could pose problems because debt stock reduction might prove to be a more transparent, and arguably more durable, form of debt relief and, as such, might foster stronger confidence-building effects.

In my view, the experience of the past few years has demonstrated that commercial banks are not predisposed to interest reduction. Instead, individual banks have preferred to choose from a broad array of menu options that allow them to take into account differing tax, regulatory, accounting, and portfolio considerations. All of this suggests that, rather than shaping deals, restricting the use of resources has done little more than unnecessarily complicate certain debt and debt-service reduction operations.

For these reasons, we would agree to modify the guidelines as proposed by staff, and I, like Mr. Végh, Mr. Evans, and Mr. Landau, would support full flexibility in the use of available resources.

Mr. Torres made the following statement:

Fund support in the implementation of the debt strategy has played a central role and has been, without a doubt, a key factor in helping some members to move towards external viability. For this reason, flexibility and readiness from the Fund to support debt and debt-service reduction operations are central for countries that are pursuing strong adjustment programs.

While our present guidelines have worked reasonably well, they also have limitations: Fund support for commercial bank debt and debt-service reduction cannot be used to enhance principal in par bond exchanges; and segmentation of Fund resources--set-asides versus augmentation--impose artificial constraints to member countries without any economic logic or need.

As the staff correctly points out, the first point is not solved if segmentation is relaxed, since neither set-aside nor augmented resources can be used to finance collateralization of principal in reduced interest par bond exchanges. In this sense, we fully support the proposed modification by the staff. However, both problems should be solved to fully increase the efficiency in using our scarce resources.

However, I have my doubts about whether we are removing the more stringent restriction among the two of them. Certainly, the recent decline in U.S. interest rates has increased the cost of principal support as compared with the financial needs of interest support; so for the time being the change proposed targets the more binding restriction. Nevertheless, as the experience with some of the member countries of my constituency indicates, segmentation was a more binding restriction for them.

In short, we support the proposal, which is a welcome step in increasing flexibility and the scope of Fund support. Allowing augmentation resources to finance the collateralization of principal of par bonds removes an unjustified Fund bias for the discount option; I agree with the remarks by Mr. Landau and others on that issue. However, we also would like to emphasize the need to remove segmentation and avoid this artificial constraint. A market-oriented approach and cost-effectiveness consideration calls for fungibility in the use of resources for debt reduction operations. I still am not convinced by the arguments against fungibility, and I think that we should take this opportunity that in modifying the guidelines to eliminate other unjustified restrictions.

Mrs. Sirivedhin made the following statement:

I will direct my comments to the specific issues raised in the staff papers.

First, I note that Argentina and the Philippines have moved rapidly in reaching an agreement on their financial packages but that no request has been made to the Board as yet, and I feel that, in keeping with the market-based approach, the Fund should avoid creating the possible misconception that it has an intervening or directive role in the negotiating process.

This being said, however, I recognize that the Fund does need to assume a strong leadership role in re-establishing cooperation between a debtor and its creditors. Recent experience with debt operations points to a number of characteristics, including the difficulties in securing debt and debt-service reduction and the protractedness of the negotiation process: raising new money has proved to be difficult for debtor countries and the amount secured is usually smaller than anticipated; and interest rate reduction has played a relatively minor role. At the same time, debt conversion has met with greater success with further proliferation of options. In this connection, I agree with the staff that it is important for the Fund not to inhibit the development of efficient instruments by limiting its support to specific options, provided that the Fund can be reasonably assured that these options would be beneficial to the country concerned in the long run. On balance, I can see the merits of Fund support to finance collateralization of principal in reduced interest par bond exchanges.

Second, on the methodology of such support, the rationale behind the guidelines of the Fund prescribing use of set-asides for debt reduction and augmentations for debt-service reduction is to ensure that sufficient reduction in the stock of debt would be attained. This nonfungibility has thus far created the favorable effect of encouraging the expansion of options in financing packages, reducing the Fund's risks and increasing debtor countries' commitment to the financing program. Strictly following the existing modus operandi, the staff's recommendation to allow use of augmentation resources to collaterize principal in par bond exchanges is appropriate. More generally, however, I am aware that the distinction currently drawn has not adequately addressed the real needs of many cases and has often led to difficulties in debtor countries coming to agreements on a bank package. In this regard, I can sympathize with the view that fungibility may be desirable between the resources available for enhancing debt and those for interest reduction. If there is a consensus in the Board for more fungibility, I could go along with it.

Third, on eligibility, under the principle of uniform treatment, a policy must be available to all members, although it is possible to orient it toward members in a particular situation. While there should be no ad hoc exceptions, countries with a large service burden, low per capita income, and lack of domestic resources, but which have undertaken strong and sometimes painful adjustment programs, should not be overlooked and need to receive more attention. Doing so would provide the necessary incentives for member countries to adopt and/or continue to pursue prudent economic and external financing policies.

Mr. Filosa made the following statement:

So far, we have decided to keep unchanged our guidelines on the modalities for debt and debt-service reduction, because they have not proven to pose undue constraints on reasonable agreements on debt and debt-service reduction in individual cases. When we decided to keep the guidelines unchanged, the understanding was that if these undue constraints to the conclusion of acceptable packages were to emerge, we would reconsider our guidelines. Indeed, we are in the situation in which, according to the document distributed for today's discussion, our guidelines could impede satisfactory agreements in at least two cases. Also, I share the staff's view that, in these cases, as well as in possible future cases, a satisfactory solution cannot be found by either resorting to ad hoc exceptions or by exercising flexibility in applying the guidelines regarding the segmentation of the use of Fund resources as between principal reduction and interest support.

In such cases as the two at hand, therefore, with the intention of avoiding obstacles to the conclusion of debt and debt-service reduction agreements that could stem from the artificial limitations incorporated in our guidelines, I am prepared to support guideline amendments along the lines described in the staff papers.

However, I cannot hide my concerns about the current developments in debt reduction negotiations. The first concern is the risk that the proposed modification of the guidelines implies an increase in requests for augmentation, the consequence of which would be that greater risks shift from the commercial banks to the Fund--although I am aware that in the case of Venezuela the situation was just the opposite.

The second concern is that it appears now that country members are negotiating debt and debt-service reduction packages that are not compatible with our guidelines. By accepting the modification of the guidelines, we would then signal to the members and the banks that we might be ready to consider further modifications to the guidelines, thereby giving implicit encouragement to members and banks to negotiate possible packages that are not compatible with any revised guidelines incorporating segmentation and other rigid limitations. We cannot exclude the fact and, indeed, we might consider it as a likely possibility, that in the future, financial innovation will be such that other modalities for debt and debt-service reduction could be envisaged in such a fashion as to be inconsistent with any guidelines having unwarranted fences and limitations.

To reduce the first risk, I would suggest that if the Board were to agree to modify the guidelines as suggested by the staff, we should also decide that, notwithstanding segmentation, the enhancement of principal collateralization of reduced interest par bonds should come first from the amount set aside for principal reduction and only if this amount proves insufficient could augmentation of access be requested by the member for interest support and collateralization of principal of reduced interest par bonds.

Also, the decision to grant the member augmentation should be taken on a case-by-case basis and only on the condition that the country is implementing a strong program, that the track record of both program implementation and timely payment to the Fund is excellent, and that the augmentation is judged necessary for an efficient use of resources for reduction of the burden of the debt. It goes without saying that other crucial elements to be considered are the level of their own resources that can be used in debt and debt-service reduction operations and the level of Fund exposure in individual countries, together with a detailed assessment that resources are used efficiently.

My agreement to the proposed modification of the guidelines, which in any case I would like to implement together with the suggestions I already made, is based on the consideration that when we agreed on the guidelines, we were prepared to consider augmentation of access to Fund resources up to 40 percent of quota, if appropriate. The modification of the proposed guidelines is, therefore, consistent with the original preparedness to permit augmentation.

In order to prevent undermining our credibility by eventually changing our guidelines in response to financial innovations, which is the second risk about which I am concerned, I would also favor a more radical and sensible modification of our guidelines, eliminating both segmentation and any rigid or unjustifiable definition of the modalities of the debt and debt-service reduction packages. In fact, I agree with the remarks made by Mr. Evans last year that segmentation is "artificial and lacking in either economic logic or operational need." Different debt and debt-service reduction techniques are, in fact, financially equivalent, although not identical. In order to be consistent with the findings of research carried out in the Fund and outside this institution, we should decide that segmentation and other artificial limitations should be eliminated. If the Board is not ready to take this decision today, I would suggest the preparation of a paper, perhaps to be discussed in a seminar session, aiming at elaborating new guidelines containing only provision for having a sound economic basis, which cannot be challenged by financial innovation and which would be capable, at the same time, of preventing excessive access to Fund resources for the purpose of allowing debt and debt-service reduction--for example, reducing the maximum access for augmentation.

Mr. Gronn said that, in view of, inter alia, the evolution of menu options under bank packages, a flexible menu approach represented an important element in the debt strategy. Consequently, in the view of his authorities, the current gap in the guidelines, on the modalities of Fund support for debt and debt-service reduction, in effect discriminated against the use of an economically efficient instrument in the menu of options, that is, the collateralization of principal of reduced interest par bonds. That could unduly complicate the eventual achievement of comprehensive debt settlements.

His chair could, therefore, support the staff's proposal to modify the current guidelines, Mr. Gronn commented. However, his authorities presumed that the amendment would not lead to any relaxation of the rest of the guidelines regarding augmentation of resources.

Mr. Sarr made the following statement:

I have no difficulties with the views presented by the staff on the need to broaden the guidelines for Fund support of debt reduction operations and to adapt them to changing market conditions. The discussion is timely, as it would enable the Fund to accommodate two cases that have recently emerged.

Admittedly, of the potential menu of options, the principal collateralized interest reduction (PCIR) option would be more expensive and would not lead to either principal reduction or interest support. It has to be recognized, however, that in the current market conditions, debtor countries might not be able to conclude agreements with commercial banks involving exclusively more favorable options.

As explained by the staff, the decline in short- and long-term interest rates in the United States has made the traditional options even less attractive to commercial banks. Therefore, and in line with our debt strategy, it is appropriate for the Fund to facilitate the conclusions of the negotiations by making such modifications, considering that all other requirements for Fund support would need to be met.

With regard to the most appropriate form of the modification, set-asides or augmentation resources, we support the use of augmentation resources to collateralize principal of reduced interest par bonds, as this would not be a great departure from our initial guidelines.

With these observations, I support the proposed amendment to the decision on early repurchase expectations to include this new type of use.

Mr. Al-Tuwaijri made the following statement:

I fully support the staff's proposal for modifying the guidelines for Fund support of debt and debt-service reduction operations. The modification is clearly a logical extension of the existing guidelines and should enable the Fund to better assist members in their efforts to restore external viability. I have only a few brief points to make on this issue.

First, reduced interest par bond exchanges with collateralized principal can be a cost-effective way of furthering external viability and catalyzing other resource inflows. In any event, the staff and Board will continue to be able to exercise their own judgment on this issue when reviewing a country's request for augmentation.

Second, the Fund should not inhibit the development of efficient instruments by the market, which aim to ease a country's debt burden. Indeed, the Fund should avoid the risk of hampering through inaction a member's efforts in this area.

If, as I hope, we go ahead with the proposal before us today, it will be important that the World Bank move in parallel with the Fund, and I encourage them to do so. Furthermore, I would extend this encouragement to other international financial institutions; here I would note the staff's reference to the Inter-American Development Bank in the context of Argentina.

Mr. Wright made the following statement:

Debt and debt-service reduction deals are voluntary in nature. The commercial banks participate only because they expect to gain from the agreements. Recent World Bank estimates suggest that, as a result of the five agreements so far agreed, the banks may have made financial gains of the order of $8 billion. At the same time, cash flow savings for the debtors are minimal or, more likely, negative, as actual payments made to the banks increase.

Yet, a country will be willing to incur these large up-front financial costs, and official creditors will be willing to take on additional risk, because they expect the operation to generate larger offsetting medium-term benefits for the country's economic development, including the opening up of new flows of finance and a return of flight capital. But as this chair has emphasized repeatedly, we should never fall into the trap of thinking that debt reduction is a goal in itself; and we should certainly not release Fund resources to support a deal before we are genuinely convinced that a strong and credible macroeconomic program is in place and is likely to remain so. It cannot be emphasized too often that without these preconditions, experience shows us that the only beneficiaries from debt reduction agreements are the commercial banks.

We now have a good deal of experience of debt reduction agreements, and we would do well to keep our guidelines under review in the light of this. I agree that there is a case for amending the guidelines in order to take account of the development of an unforseen menu option. While, as the staff point out, the lack of Fund resources for collateral on par bonds has not so far proved to be a major constraint on the agreement of menus--and it may even have encouraged debtors to find further resources from elsewhere in order to help finance the deals--I can see that in some circumstances it could be an unwelcome and inefficient constraint. I can therefore agree to the proposed change.

Finally, I have listened with interest to the comments of Mr. Evans, Mr. Landau, and others on the issue of segmentation of Fund support more generally. I would emphasize that there is no necessary link between any agreement we may reach today on the proposal before us and the issue of segmentation. This chair has consistently recognized the potential risk of segmentation resulting in rigidities in Fund support for debt reduction operations. For this reason, we have said that we should always have available the possibility of applying them flexibly on a case-by-case basis. I could, nevertheless, like Mr. Filosa, support a more general review of this issue by the staff. I would hope that any such review would pay careful attention to necessary safeguards that would need to accompany any change in the guidelines. We would need to ensure--and the review would have to address this issue--that such a change in the guidelines did not alter the balance of burden sharing, nor should it open the way for the Fund to become the passive financier of unbalanced menu items.

In light of earlier discussion, I can think of no case, certainly in my time here, in which the Board has seriously challenged the structure of a debt reduction deal even when this has been patently unsatisfactory. I am not sure that guidelines have direct bearing or not--banks may be right to play games if guidelines preclude economically efficient choices. What is important is that the Board should examine fully and be prepared to challenge unbalanced packages--not that we should try to rule them out through the existence of guidelines, which may or may not be appropriate for the circumstances, and that is why I would like to see a review of this issue. The Fund's role in financing such packages is already, in my view, too passive. We need to address this problem. Any review might also consider whether a case could be made for limiting access to such Fund support to countries with extended arrangements only and whether downside contingency arrangements should be incorporated in Fund support.

Mr. Monyake said that the heavy debt overhang continued to be an obstacle to the attainment of satisfactory growth and external viability for a number of countries, even those undertaking strong economic reform programs. As those countries persevered with their adjustment efforts, it was important that they be assisted with adequate debt relief that would provide a durable solution to their predicament. Against that background, it was only appropriate that Fund support for debt and debt-service reduction schemes, which was a critical pillar of the debt strategy, be strengthened where necessary; that would be in the interest of both creditors and debtors. The Fund should be prepared to show flexibility, the need for which was recognized at the time the Board agreed on the direct involvement of the Fund in debt and debt-service reduction arrangements. Therefore, he supported the modification suggested by the staff.

Mr. Kafka stated that he supported the staff proposal for amending the guidelines. He had always opposed, and certainly had not been convinced about the advantages of, segmentation, and he would gladly go along with its total abolition.

Mr. Goos made the following statement:

The proposal before us raises a number of difficulties and concerns. First of all, in a formal sense the staff is certainly correct when it recalls on the bottom of page 16 and top of page 17 the Board's willingness to review from time to time the appropriateness of the guidelines for Fund support for debt and debt-service reduction operations in the light of innovations and adaptations of market instruments for such operations. However, it does not suffice to support new financing techniques simply on the ground that they are economically equivalent with other debt and debt-service reduction instruments already eligible for Fund enhancements. More specifically, I found it difficult to accept that member countries and commercial banks negotiate debt restructuring agreements well knowing the inconsistency of those agreements with the existing guidelines for the provision of Fund enhancements but do so obviously with great confidence that the guidelines will be adjusted to their needs. We have to be careful that the Fund, by accommodating such practices, will not create the perception of dancing to the tune of commercial banks or individual members.

The existing set of guidelines is the result of delicate and well-balanced considerations based inter alia on the desire to induce banks to provide effective debt and debt-service reduction and to limit the transfer of risks from private to official creditors, i.e., to the Fund (see, for example, the conditions for augmentation as reproduced on page 17, footnote 1). The argument that reduced interest par bonds would be equivalent to other debt restructuring instruments and, hence, that their exclusion from Fund enhancements would make little sense, strikes me, therefore, as a rather moot point. I am much more concerned about the risk that a decision today to widen the scope for Fund enhancements is likely to invite requests tomorrow for further relaxation of the guidelines, including requests to abolish segmentation, which I could not support.

Moreover, there is the risk that the proposed additional collateralization of par bonds will generally induce the banks to refrain from principal reduction operations in the future. This would run counter to the intention of the Brady initiative of achieving a lasting reduction in the debt burden. A number of previous speakers have referred to the attractiveness of debt-service reductions, because of the cash-flow implications. But I recall that the emphasis when we discussed the Brady initiative was also on debt stock reduction, because it was felt that the high stock of debt would work as a psychological barrier to investments and to direct capital inflows. So I think one has to keep in mind both aspects of the debt problem.

I was also somewhat surprised by the staff's justification of its proposal on page 17 (second paragraph) that since interest support has become less expensive relative to principal support, implying--as I read it--a reduced demand for augmented resources, one could use those savings for other purposes. This reasoning seems to ignore the fact that the access guidelines for Fund enhancements do not constitute entitlements but rather ceilings only. And I think the same point can be made in response to suggestions of previous speakers who said that we should forget about segmentation and support debt reduction packages that we consider to be economically efficient. Everyone knows if we take such an approach and we have a certain access limit, we will in all likelihood exhaust that access limit in each and every case.

Against this background, I find it difficult to give my unqualified support to the staff proposal. However, I think Mr. Dawson has offered an interesting solution that would go a long way toward meeting our concerns, especially as it would help prevent the banks from emphasizing excessively reduced interest par bond exchanges. I therefore support Mr. Dawson's proposal.

Mr. Chatah said that he supported the staff proposal. More generally, on the question of segmentation, his chair, as a matter of principle, was not disposed to having restrictions on the type of activity under discussion unless they could be explicitly and convincingly justified. In his view, there was currently not a strong justification; nor had there been one in the past. If restrictions were to be imposed, Directors should be convinced that their absence would produce an inefficient outcome, which did not seem to be the case. The references by some speakers to an unbalanced outcome were not clear to him. Mr. Goos had introduced in a sense a concept of externality--a psychological effect of a certain combination of menus. One had also to be convinced that the particular set of guidelines could improve that inefficient outcome, which he doubted. In sum, he could support Mr. Filosa's suggestion to perhaps look at the various issues in the future.

Mr. Rouai said that he supported the broadening of the guidelines for Fund support for debt and debt-service reduction operations to allow use of augmentation resources to finance the collateralization of principal in reduced interest par bond exchanges. However, the staff should further comment on the underlying reasons behind the increasing choice by banks of the reduced interest par bond option.

Mr. Posthumus commented that he was surprised that no one had remarked on the statement in the staff paper that modifying the guidelines could lead to increased requests for augmentation and, therefore, to increased requests for Fund money, which would affect the Fund's liquidity position. Apparently, that possibility was of no concern to other Directors. Still, the staff could usefully comment on whether it had any idea how much additional call on the Fund's resources might be involved, although that question was admittedly not easy to answer. In any event, he wondered why the staff's current proposal had not been made three years previously, when the debt strategy was formulated. At that time, the original staff proposal was that 25 to 30 percent of set-asides would be made available for either debt reduction or debt-service reduction--in other words, they would be fully fungible at that time. Added to that original proposal was a proposal for augmentation up to 40 percent. The segmentation of the usage of the two sources of finance was then introduced, because the Board at that time wanted to direct the usage of the money that the Fund made available for specific purposes; and directing the usage into specific purposes, of course, meant limiting the use for other purposes. That latter aspect was certainly for his chair one reason why it had supported the segmentation, and why he continued to favor segmentation; money was fungible, and with the segmentation the Fund could limit the use of its resources to a greater extent than it could otherwise. Introducing fungibility at the present stage, therefore, would result in a much larger use of Fund resources for the intended purpose than was envisaged in the original staff paper three years ago. Nevertheless, he had no objection to the proposed restricted fungibility currently proposed by the staff, namely, use of augmentation to collateralize principal in par bond exchanges.

He was somewhat attracted by Mr. Dawson's proposal, Mr. Posthumus added. However, he doubted whether the Board could make case-by-case judgments in the cases concerned, particularly if the debt agreements were fully concluded before they were considered by the Board. In addition, experience suggested that the Board always approved all the debt support proposals submitted for its consideration.

Mrs. Martel recalled that Mr. Landau had stressed that, as money was fungible, segmentation seemed irrelevant in terms of the extent of the Fund's exposure. In addition, the staff's current proposal would not increase the Fund's exposure, because if augmentation was not employed, the Fund might be forced to accelerate the use of set-asides.

Mr. Posthumus responded that he was not convinced by the argument that the Fund would be forced to accelerate the use of set-asides. He wondered who could be expected to force the Fund to do so if there was a guideline that placed certain limitations on the use of set-asides. The Board should not be forced--and in all likelihood would resist proposals--to transgress the limits of the guidelines.

Mrs. Martel commented that perhaps the term "force" was not fully apt in the circumstances that were under discussion. But the Board had already been encouraged to accept set-asides in the past, and it was clear that the Board should look very carefully at the track record of each country making such requests. The Board had apparently had some difficulty in doing so in the past.

Mr. Che stated that he accepted the staff's recommendation to modify the guidelines in the context of the present discussion.

Mr. Fukui considered that the issues of fungibility and segmentation involved some judgmental factors. During the discussions on debt reductions, emphasis had been placed on the options of cash buy-backs and discount bonds. As a result, his Government had taken on some of the burden in helping to support par bond swaps. His authorities felt that they were playing a larger role than others in that connection, but they also felt that greater emphasis should be placed on par bond swaps. They did not believe that there should be any sort of bias against that option. For that reason, they supported the staff's proposal and favored retaining the current segmentation, which would give an appropriate emphasis on the necessary use of par bound swaps.

The Deputy Director of the Exchange and Trade Relations Department said that there had been little progress in employing a phased approach to debt reduction. The banks in particular, and possibly the countries concerned, had been reluctant to agree, well in advance of the availability of enhancements, to the terms and conditions, as they recognized that the conditions might change by the time the debt agreements were finalized. Negotiations were under way in which some form of phased approach was at least being discussed, and there seemed to be some disposition to proceed further in that direction. The staff would continue to follow those negotiations and would report to the Board upon their conclusion.

It was difficult for the staff to estimate how much additional recourse to Fund resources might result from approval of the proposed use of augmentation, the Deputy Director said. When augmentation was introduced three years previously, the staff had expected a substantially larger number of requests for it than had in fact been made thus far.

He did not have reason to think that the proposed use of augmentation would change the balance of debt reduction and debt-service reduction in an aggregate sense, leading to more requests for Fund resources, the Deputy Director continued. The staff had simply wished to make clear that the proposal did involve possible augmentation. Among all the current debt agreements, there was roughly a balance between debt and debt-service reduction, and the staff saw no particular reason why the approval of its proposal would necessarily change that balance.

The specific instrument under discussion at the present meeting had not been raised at the time of the discussion of the guidelines in 1989, the Deputy Director recalled. Following that, rapid progress was being made on debt agreements, and the ability to finance them had not appeared to be a significant problem. It was only more recently that it had become apparent that the gap in the guidelines might lead to more significant constraints.

It would of course have been preferable to put forth the staff proposal outside the context of ongoing individual country cases, but when the potential constraints had become clear, the possible use of the instrument in question by the Philippines was already in prospect, although not actually imminent. The staff had decided at the time not to make its proposal in a country-specific context, but rather to try to introduce it into the general debt discussion, and the proposal was therefore presented in the general paper on the management of the debt situation (EBS/92/52) circulated in March 1992. In the meantime, the Argentine case had also arisen; and there would undoubtedly be additional cases in coming months that could also involve that instrument.

The staff certainly had not meant to imply that the possibility of "augmentation" should be seen in any way as an entitlement, the Deputy Director said. Mr. Dawson had mentioned a few criteria that might apply, and most of them would give no difficulty to the staff; they were in fact integral to the established guidelines, under which a judgment should be made by the Board that a country's debt agreement was cost effective. However, Mr. Dawson had mentioned that use of the various menu options should be balanced so as not to disadvantage debt reduction. If Mr. Dawson's point was that there should be option-by-option equivalence within a menu, that would give the staff some difficulty. Pricing of menu options was, to some extent, an art and not a science, as it depended heavily on expectations about interest rates and payments performance. There had been substantial differences among options in all of the menus that had come forward, and under the staff's pricing method the staff looked at the package as a whole and judged it from an overall cost-efficiency and cash-flow point of view, as well as in terms of its consistency with the country's external position. The staff preferred to retain that approach. As Mr. Prader had noted, there were certain safeguards attached to the use of augmentation, which involved specific Board consideration of the justification for augmentation, and a proposal for augmentation gave the Board an added opportunity to assess the quality, balance, and effectiveness of a country's debt package.

Mr. Dawson said that he recognized the staff's concern: the existence of an appropriate balance in a debt agreement would of course involve an element of judgment. Because of the way in which the markets were segmented from the viewpoint of both creditors and debtors, there could be unusual and apparently inconsistent pricing. The existence of a menu of options meant that there should be a balance in the extent to which individual options were employed in particular cases. The fact that some instruments involved more or less enhancement, or cash flow, or some other measure of equivalence of use of various options, did not necessarily mean that a debt agreement would be characterized by a lack of balance. His concern was that there could be debt agreements that involved, say, 90 percent use of one particular menu option, which would clearly indicate that the agreement was not balanced. The question of balance was very much one of judgment and could not be determined by any particular qualitative or quantitative indicator.

The Chairman commented that the discussion had clearly shown that, in continuing to apply the debt strategy, Directors wished to remain aware of the need to make sure that the various instruments employed would work well while preserving the discretion of the Board in supporting individual debt operations. Most speakers seemed to agree that the staff proposal was reasonable and should be adopted.

The guidelines on Fund support for debt operations were contained in his summing up of the discussion on Fund involvement in the debt strategy at EBM/89/61 (5/23/89), the Chairman noted. As he understood it, the consensus of the present discussion was as follows:

> The Executive Board has agreed to modify the guidelines on Fund support for debt operations to allow the use of augmentation resources to collateralize principal in reduced interest par bond exchanges. The guidelines and requirements regarding Fund support remain the same in all other respects.
>
> It will be necessary to revise in a consistent fashion the language of the decision on early repurchase expectations in relation to Fund support for debt and debt-service reduction operations. A proposed amendment will be circulated for adoption on a lapse of time basis.

During the discussion, the Chairman continued, some speakers had suggested that specific aspects of the guidelines might warrant further consideration on another occasion. Those issues could be looked at further in the coming period, perhaps during the discussion on the debt strategy that, as agreed at the latest review of the work program, was to be held in September 1992.

Mr. Goos commented that he wished it to be clearly understood that he accepted the staff proposal, but only with the safeguards proposed by Mr. Dawson.

Mr. Landau said that he hoped that the staff would prepare a paper assessing, in light of experience, the advantages and drawbacks of various options, including the issue, mentioned by Mr. Evans, of whether or not there was, effectively and legally, the kind of flexibility that some Directors preferred.

The Chairman remarked that he had noted the suggestion to hold a separate discussion on the guidelines. He doubted whether the positions of Directors had changed in such a way that the proposed discussion would result in the outcome that Mr. Landau preferred. The staff would look carefully at the papers that had already been circulated to the Board on the occasion of the previous relevant discussions to determine whether they adequately covered the issue of the advantages and disadvantages of segmentation. If they did not do so, brief additional material could be circulated for discussion.

The Executive Directors concluded their discussion on the modalities of Fund support for debt and debt-service reduction.

2. ROMANIA - 1992 ARTICLE IV CONSULTATION, AND REQUEST FOR STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1992 Article IV consultation with Romania and a request by Romania for a 10-month stand-by arrangement in an amount equivalent to SDR 314.04 million (EBS/92/79, 5/5/92). They also had before them a background paper on recent economic developments in Romania (SM/92/96, 5/8/92).

Mr. Posthumus made the following statement:

Romania is entering its third year of transition from a centrally planned economy to a market-oriented economy. The transition is being shaped by many factors, past and present. It should be pointed out in particular that in the 1980s the centrally planned economy was almost completely geared towards an accelerated repayment of foreign debt and towards large unproductive investments. As a result, Romania's capital stock and infrastructure deteriorated substantially in the 1980s. This, and the abandonment of the planning system in 1990, and the collapse of CMEA trade and of trade with Middle East countries in 1991, have led to a very serious and protracted reduction in economic activity. When Romania entered its first Fund-supported program a year ago, there was no foreign debt and, therefore, no need for debt rescheduling and debt-service reduction. There was no longer a central plan, although enterprises continued to an extent to function as if there was. And there was no market-oriented economy yet. At the end of the first Fund-supported program, hardly any foreign financing other than from the Fund had become available.

The results of the first Fund-supported program and developments in the first months of this year bear witness to the strong commitment of the authorities to the strategy of stabilization and reform. As of end-April 1992, virtually all foreign trade restrictions had been eliminated. Also 83 percent of consumer goods and services and 89 percent of investment goods and export prices have been liberalized. On May 5, consumer subsidies were reduced by 25 percent. Inflation at the end of the year was much higher than expected, but wages have been kept under control. Thus, inflation declined from 19.5 percent in January 1992 to 4.7 percent in April. The consolidated general government budget deficit in 1991 was kept to 0.8 percent of GDP, and for 1992 the budget aims at a deficit below 2 percent of GDP; during the first four months of 1992 the budget has been in surplus. Also, monetary policy has been kept tight, with the money supply increasing by less than 4 percent during January-April of this year.

In addition to the liberalization of prices, the privatization process has clearly started in 1991, and the legal and institutional framework to establish the central role of private ownership and decision making has been developed. A bold and in a way an original law on privatization was passed last year; the distribution of ownership certificates to the citizens has started. However, enterprise behavior has not yet changed sufficiently, as the large increase in interenterprise credits last year made clear. Land has been restituted to private owners; over 80 percent of arable land is now in private hands. More than half of state-owned housing units have been sold to tenants.

Monetary policy aims at bringing interest rates at a level that is positive in real terms; recently a decision was taken to raise the refinancing rate of the National Bank to 80 percent. The unification of the official and market exchange rates in November last year was not immediately successful, but new measures have now been taken to make the unification effective.

As in other Eastern European countries, the introduction in Romania of a market-oriented system in an environment of as much financial stability as possible is politically difficult; the outcome is certain, but the timing is not. Romania's own efforts are crucial, and in my view the authorities have shown that they fully realize this. The Fund's support in 1991 was crucial as well. In this respect, my Romanian authorities feel very uncomfortable about their present inability to complete the repurchase expectation of the overcompensation on the 1991 drawing under the oil element of the CCFF; it is their firm intention to effect this repurchase as soon as possible.

I should like to add that, following approval of the proposed stand-by arrangement and following the expected repurchase, the Board should call upon the international community to increase its financing of Romania's transition to a market-oriented economy, even beyond the present conservative estimates of the balance of payments gap.

Mr. Noonan made the following statement:

I am largely in agreement with the staff's appraisal, including their endorsement of Romania's strict fiscal stance, and I intend to support the proposed decisions. Consequently, I will confine my remarks to seeking clarification on a couple of questions and to making some points on the 1992 program.

But first I would like to salute the reform efforts of the authorities over the past year. Their efforts in stabilizing the economy were only partly effective; nevertheless, I can note with satisfaction the progress made in liberalizing prices and trade and in establishing the legal and institutional framework for private ownership and decision making.

However, notwithstanding the scope and pace of structural reform, output further declined by an estimated 13 percent in 1991 following the substantial decline in 1990. External factors played an important role in this further decline, but the staff appraisal also identifies domestic factors as being partly responsible, in particular the disorganization of the economic system and an inability to restructure the enterprise sector. I am not certain whether the staff wishes to imply that these domestic factors--which contributed to the magnitude of the output decline--were within the discretion of the authorities to overcome and could realistically have been avoided by adherence to the agreed program. In other words, does the staff see the domestic contribution to the output decline as being the result of slippages and inefficiencies in implementing expected reforms--reforms which underlay the original assumption of zero change in GDP in 1991? I would appreciate staff clarification. The alternative to this implication would seem to me to be that the original assumptions about the scope and pace of structural reform were too sanguine, and perhaps not realistic.

As regards the external factors contributing to Romania's difficulties, I would question whether the demise of the former CMEA trading arrangements, while massively disruptive, adequately explains the continued decline in traditional regional trading, and in particular the apparent failure to find ways to facilitate a recovery. When we discussed Bulgaria last month, we were told that little, if anything, had been done to restore trading links on the basis of comparative advantage in the former CMEA area. Indeed, I inferred that the position was possibly deteriorating further, with Russia insisting on payments conditions that were not conducive to progress. I recognize that trade issues may not be the prime concern of this institution, but some resolution of these issues would, I suggest, be very helpful to a successful stabilization and growth program. Again, I would appreciate a staff comment.

I would like to address the rest of my remarks to the proposed economic plan for 1992 and raise a couple of points on the proposed stand-by arrangement.

As regards the 1992 plan, the establishment of a firm, credible nominal anchor is considered an essential element of a stabilization program. We have some concerns that the chosen anchors--a tight incomes policy and the targeting of the monetary aggregates--will prove to be both firm and credible. For instance, given the upcoming elections in Romania, there may be significant pressure on the Government to soften wage policy, perhaps by increasing the coefficient of indexation to offset falling real wages. It is also doubtful that in an economy undergoing such significant financial restructuring as Romania, that the relationship between money and prices would be stable. Targeting the monetary aggregates may therefore prove to be less than effective in controlling inflation, especially when it seems that exchange rate depreciations may be directly and indirectly giving their own impetus to inflation. Consequently, while a fixed exchange rate anchor would probably be premature at this stage, given Romania's reserve position, I wonder whether it might be worth giving consideration to supplementing the chosen anchors by shadowing an appropriate exchange rate as an indicator of the adequacy of the policy stance.

As regards the stand-by arrangement, the proposed disbursement profile is front-loaded, with the largest instalment expected to be available in early June. We would have preferred a somewhat different profile, whereby disbursements would increase following the putting into effect of the many proposed reforms slated for "midyear," in order to convey perhaps a more appropriate signal and incentive to the authorities to realize their stated objectives.

I also note the authorities' discomfort with their inability to meet their expectation of early repurchase, which arose from an overpayment on their CCFF arrangement last year. I would strongly urge the authorities to fulfill their claim that this will be done shortly, preferably prior to making any drawings on the proposed stand-by arrangement.

Finally, I note that the amount of external financing under Romania's 1992 program has been scaled back significantly. This seems to be in response to the 1991 experience. I have been assured that Canada's contribution of C$24 million by way of external financing support will be disbursed shortly. Delay was occasioned by both administrative and parliamentary processes which proved lengthier than originally expected. My Canadian authorities, however, would like to stress that their balance of payments assistance is conditional on the Romanian authorities taking whatever measures are needed to enable official financing to be replaced with private financing. The official assistance is transitional and should not be considered an annual commitment. Indeed, my Canadian authorities believe that every effort should be made to ensure that future Fund programs are fully funded when presented to the Executive Board.

In conclusion, I wish the Romanian authorities success in implementing their 1992 program.

Mr. Prader made the following statement:

Romania has been in a very difficult situation ever since beginning its transformation process in 1989, and we are very much impressed by the authorities' determined adherence to their stabilization and structural reform programs. The Government's determination to continue the painful adjustment process is most commendable, particularly since the external environment has been more unfavorable than initially expected and external financial assistance has fallen short of expectations.

We agree with the staff and the authorities that Romania's first priority is to establish a stable macroeconomic environment as a sound basis for continuing the reform process. We accordingly support the Government's ambitious adjustment program for 1992, aimed at halting the decline in real economic activity, bringing down inflation, and improving the external position. However, we see some underlying obstacles to the success of stabilization policies, particularly in the fiscal and monetary area. The most critical is the continued decline of GDP, now in its fifth straight year; it seems rather uncertain that this trend can be reversed by 1993.

The experience of other East European countries has shown that the economic slowdown accompanying the transition process is both deeper and more tenacious than predicted. The severity of Romania's output shock due to rapid liberalization and the disappearance of CMEA markets, and the obsolescence of its means of production, make it likely that the supply response will be even slower to appear, while the shortfall in external financing has further limited the resources available to support recovery. And finally, the experience of other transition countries seems to validate the concern we expressed during the last review of Romania's situation that the economic slowdown attendant on the transition process will shrink fiscal revenues and intensify the contraction of the economy.

Nevertheless, given Romania's lack of domestic and external resources, we see no other way of weathering the present recession than by continuing tight fiscal policies and pressing forward with structural reforms, particularly institution building.

In the financial policy area, the staff is correct that, despite the slight deterioration from the 1991 level, the targeted fiscal deficit, at 2 percent of GDP, reflects a significant effort in the face of continued budgetary pressures stemming from the declining output. The expected decline in revenues will constrain expenditures. Against the threat of slippages in the fiscal program, we are glad the authorities have prepared contingency revenue measures, but we fear the room for such measures is limited by the strong recessionary trend. Could the staff elaborate on this issue?

In any case, it would seem to be of utmost importance to adhere to the tax reform plans outlined by the Romanian authorities, i.e., to have a comprehensive market-compatible tax system in place by early 1994. In addition, we would urge the Romanian Government to formulate and implement a number of reform measures designed to improve the effectiveness of the tax collection system.

Likewise, it will be an arduous task to keep public spending under control. It seems questionable that better targeting of social transfers plus some subsidy cuts will suffice to reduce expenditures as planned. In sum, we agree with the authorities and the staff that fiscal policy should be tight to achieve stabilization, and that it will require considerable perseverance and flexibility to meet the fiscal targets outlined in the Government's adjustment program.

In the area of exchange rate policy, we find it regrettable, though understandable, that the unified fixed exchange system has not been functioning. The introduction of this system may have been premature, in the face of massive external and internal imbalances and without the support of properly functioning market institutions. We agree with the staff that a single floating rate after the necessary devaluation would be a more appropriate system for Romania in the current circumstances. While we welcome the May 22 decision to let the exchange rate be determined by the market, we wonder whether this move should not be accompanied by some temporary protection of domestic production whose duration would, however, be subject from the outset to strict and credible limits. Excessive depreciation of the leu is to be avoided. The experience of other transition countries shows that the gradual liberalization of imports, starting with investment goods, raw materials, and some semi-finished products, is a viable reform path, especially in cases of rather limited export potential, insufficient international reserves, a stabilization process still in the first stages, and market reforms that have not yet reached their critical mass.

In the monetary area, strict implementation of the program targets is essential for achieving the stabilization objectives. The data presented in the staff representative's statement today on the recent sharp decline in the inflation rate are welcome news. It will nonetheless be difficult to reduce inflation and hold it down permanently. In light of last year's negative outcome, it is especially important to ensure that arrears between enterprises do not undermine tight monetary policy. It is imperative to impose stronger financial discipline for enterprises, especially through the enactment of the law on bankruptcy and strict enforcement of bankruptcy procedures. We welcome the replacement of bank-specific administrative ceilings with indirect methods of monetary control. Interest rate liberalization should be accelerated in order to improve the efficiency of credit allocation and to encourage financial savings.

The structural reform elements of the program rightly focus on enterprise reform, which is a precondition for the sought supply response. We welcome the Government's recent steps to create market conditions for enterprises. Since it is the most important ingredient of market-based decisions, enterprise discipline should be strengthened by eliminating all preferential treatment, including compensations, preferential financing, and monopolistic privileges. Since the best approach to enterprise restructuring is privatization, we welcome launching of a wide-ranging privatization program involving most of the state assets. However, we have some doubt that the privatization method chosen for the majority of state enterprises will provide the full management improvement of real private ownership so long as these enterprises are largely owned by state related agencies. We applaud the authorities' intention of encouraging the establishment of new private enterprises. Experience shows that this is the most effective way of creating an efficient private sector, and we therefore urge the authorities to provide favorable market conditions and equal access to financial resources for new private enterprises.

My last remark is on incomes policy as one of the basic pillars of stabilization. In this area, the stance adopted by the authorities, which combines wage compensation on the order of 50 percent of inflation with punitive taxes for excessive wage increases, is to my mind adequate, but only in the short run. From the point of view of countries with experience in social compromise, it will be especially important to develop a collective bargaining system based on a consensus among the social partners, and this could help to solve some of the problems that Mr. Noonan has pointed out in connection with the country's incomes policy.

Mr. Tabata made the following statement:

The Romanian authorities continue their strenuous efforts to transform the command economy to a market one, under extremely difficult circumstances. I am impressed by the recent favorable outcomes, as mentioned in Mr. Posthumus's statement. However, it is a matter for regret that the track record of the former stand-by arrangement was not favorable, even taking into account the collapse of CMEA trade, the shortfall in external assistance, and social unrest. Regarding the general picture of the proposed stand-by arrangement, I would like to comment on the specific relationship between the scheduled first drawing under the coming stand-by arrangement and the expected repurchase of the overcompensated amount under the former CCFF. While the repurchase of the former CCFF drawing, SDR 153.40 million, is expected to be implemented by the end of June, the first drawing under the stand-by arrangement, SDR 157.02 million, is approximately the same amount as the repurchase and is scheduled at the beginning of June. These two figures clearly show that the front-loaded first drawing under the coming CCFF is intended to finance the repurchase to the Fund.

This type of lending, i.e., lending Fund resources to members for the purpose of repaying their former borrowing, is a most risky operation and against the principle of the Fund as a monetary institution.

Regarding fiscal policy, the authorities plan to maintain their budget deficit at approximately 2 percent of GDP in 1992. However, taking into account the fact that the expected decline in GDP of 5 percent is sure to have adverse effects on the revenue side, it seems extremely difficult to attain the target. Contingent revenue enhancement measures will not change the vulnerability of the revenue structure. Consequently, further cuts in enterprise subsidies are needed.

On the monetary front, I appreciate the authorities' efforts to sterilize the excess liquidity caused by the credit increase under the global compensation scheme. However, the authorities' intention to utilize indirect measures for the implementation of monetary policy seems to be difficult to execute, because an efficient money market has not yet been introduced. At the initial stage of the economic reform, direct measures seem to be useful for attaining policy objectives.

Let me turn to exchange rate policy. The authorities' current policy stance, which aims at maintaining a higher exchange rate than the market rate by frequent intervention, is not sustainable and only delays the reform of the corporate sector. The equilibrium exchange rate should be determined by market forces.

Regarding structural policy, the most urgent measure that the authorities should take is to prepare a system that would enable inefficient public corporations to become bankrupt. In this connection, I appreciate that the bankruptcy law has been submitted to Parliament.

Finally, I would like to reiterate that, taking into account the extremely low level of Romanian foreign reserves, the delay in the repurchase, and the Fund's lending its resources for the purpose of repayment of the former purchases might be allowed. However, this should be the exceptional case.

With these comments, I support the proposed decision.

Mr. Al-Tuwaijri made the following statement:

In early 1991, the Fund gave its support to the Romanian authorities' economic transformation and stabilization effort. The commitment and determination of the authorities to the reform process were demonstrated by the bold and comprehensive nature of the program, which was supported by a stand-by arrangement. However, progress on both the stabilization and structural reform fronts was mixed, and the outturn fell far short of the original expectation. The staff attributes much of this result to an unfortunate confluence of external factors, including the collapse of CMEA trade and difficulties regarding external financing. However, domestic factors also contributed critically to the weak performance of the Romanian economy.

Effective enterprise reform is key not only to the successful transformation of the Romanian economy, but also to macroeconomic stability. With the benefit of hindsight, it is clear that the inability of enterprise managers to adjust to a markedly different market and price environment within the space of one year, coupled with the sharp contraction in demand, led to substantial disruption in the economic system. In the absence of hard budget constraints, the financial system was contaminated through the spread of interenterprise arrears and the subsequent Government-directed bank bailout. Furthermore, these events have added to the important need to clean up balance sheets of banks. Of course, these difficulties were compounded by external shocks, which amplified the magnitude of the changes to which economic agents had to respond. However, these developments also indicate that the effective commercialization and privatization of state enterprises are likely to take several years, and that this reality should be taken into account in the design and expectations of our programs.

As regards the program before us, the authorities have taken a number of crucial measures, which should further enterprise reform and keep the moral hazard risk to a minimum. Nevertheless, we should still be careful to avoid overoptimism in this area. The invigorated privatization program is ambitious, but it will take time to implement and for potential buyers to digest all the assets on offer. In the meantime, with a strengthened bankruptcy law in place, it is essential that managers' progress along the free market learning curve is accelerated. The sharp rise in unemployment, projected for 1992, is perhaps a sign that this learning process is under way, and that managers are now shedding previously hoarded labor. However, I note that some 320 enterprises are being excluded from both commercialization and privatization until later. Such a delay could be a source of concern, and, therefore, I have some questions for the staff. Do these enterprises represent a substantial share of domestic output and public-sector employment? What has been their financial performance in the past year?

Looking more broadly at the program, it is comprehensive and relatively ambitious. In particular, I welcome the prior actions, the use of conservative external financing assumptions, and the early identification of fiscal contingency measures. As regards the stabilization framework, I would put more weight on the exchange rate. For the time being, I agree with the view that a fixed exchange rate regime is not appropriate or feasible. Nevertheless, the exchange rate should be used as an indicator of the effectiveness of the chosen nominal anchors, namely, monetary and wage policies. The visibility of the exchange rate as a price signal, together with the experience following the sizeable depreciations last year, suggest that the impact of exchange rate movements on inflation, especially through influencing expectations, is considerable. Therefore, following the recent sharp adjustment in the exchange rate, a degree of relative stability through appropriate financial policies could prove useful. In this respect, however, I would welcome some clarification from the staff on the statement on page 13 of the staff report that "...the volume of exports is assumed to grow by 5 percent, the adjustment effort takes hold, and significant gains in competitiveness through exchange rate and trade policy are achieved." Does the staff envisage further significant depreciation of the nominal exchange rate, or are the gains in competitiveness a result of the large depreciation at the end of last year?

Turning to the external outlook, I am glad to observe that the role of the Fund in providing financial support has appropriately declined relative to other creditors. Nevertheless, I am concerned by the cautious assessment of Romania's capacity to service its obligations to the Fund given by the staff. In particular, I would note that this capacity, and the balance of payments outlook in general, are predicated on considerable external financing inflows. Moreover, we should not ignore the likelihood of further Fund arrangements with Romania, which would transform the 1995 peak in payments due to the Fund into a plateau. This prospect calls for a strong and sustained transformation effort by the authorities.

The Romanian authorities continue to move ahead with an impressive array of measures to transform and stabilize their economy. The rewards of these efforts are taking time to emerge, but I commend the authorities' continued steadfast commitment. With these remarks, I support the proposed decisions and wish the authorities success in their efforts.

Mrs. Hansen made the following statement:

We are in broad agreement with the staff that Romania has made significant progress over the last year in liberalizing its economy. Price decontrol is well advanced, privatization is under way, the exchange system has been unified and restrictions on current transactions removed, and important structural reforms have been undertaken in the areas of tax policy and monetary policy management. I would add that we also commend Romania's trade liberalization, which we see as an essential means of promoting competition and helping to get domestic prices "right." Contrary to Mr. Prader's suggestion, we would be sorry to see this process reversed.

Although Romania's stabilization goals have been more illusive, under the circumstances, the authorities have, in many respects, done a remarkable job of adhering to their program objectives. Notably, fiscal performance was stronger than expected, notwithstanding the precipitous decline in economic activity, a shortfall in external financing, and a difficult external environment.

This being said, the introduction of the global compensation system was indeed unfortunate--not only because of the ensuing credit expansion that far exceeded the Fund target, but also, and more importantly, because of the doubt it casts over the authorities' future efforts to subject public sector enterprises to financial discipline. Having been forced to bail out ailing public sector enterprises once, the authorities will have to work harder now to establish the credibility of their intentions to enforce hard budget constraints in the state enterprise sector in the future. In this connection, we welcome the staff's report that the draft law on financial discipline has passed the Senate, and we hope that it will soon pass the lower house, as well. Parliamentary approval and the subsequent implementation of this legislation will be an important element in the midterm review of the stand-by arrangement.

On the fiscal front, we see that Romania faces intensifying budgetary pressures as the impact of its decline in output filters through to the fiscal accounts in the form of reduced revenues and increased social expenditure. In this connection, we welcome the introduction of the "flash" reporting system and the identification of contingency revenues measures to keep the program on track. We suspect, however, that more could be done on the expenditure side by eliminating some subsidies and targeting others more carefully on those in greatest need. At 10 percent of GDP, subsidies represent a major drain on public finances.

With regard to interest rate policy, we welcome the recent increase in the refinancing rate to a level that is, at last, positive in real terms. It is critical to have interest rates at positive levels, not only to limit the demand for credit and improve resource allocation, but also to make domestic financial assets attractive and, in so doing, promote greater exchange rate stability under Romania's floating exchange rate regime.

The next step will be to increase competition in the banking system so that positive interest rates will be set by market forces, rather than by government fiat. In this connection, we welcome the establishment of four new commercial banks, which we hope will operate according to market principles and, in so doing, provide competition in this sector. We also look forward to the planned break-up of the behemoth Savings Bank that now dominates the banking sector. We would be interested in knowing what the timetable for this is and how the authorities intend to ensure that the current national monopoly on deposit taking is not simply replaced, at least in the short term, by local monopolies on the part of the newly independent branches of the Savings Bank.

The authorities' ability to adhere to a rigorous wage policy is obviously key to the success of this program. The 0.5 wage bill coefficient for the period of May through August should facilitate the authorities' efforts to bring down inflation, and we hope that a similarly favorable agreement can be worked out for future periods. Needless to say, the authorities' ability to contain inflation through rigorous financial policies will have a major bearing on the kind of wage settlement that unions are willing to accept.

Still on the subject of wage policy, we would be interested in understanding a little better how the system takes account of increases in enterprise profitability. Insofar as increased profitability stems from increased worker productivity, and insofar as there is a need to increase worker incentives, there would appear to be a case for higher wages. But in a system that lacks much, if any, competition among enterprises, how it is determined how much of an enterprise's increased profitability should go to labor, rather than to increased investment in plant and equipment or lower prices to the consumer?

Turning to the exchange system, we welcome the authorities' decision to allow the exchange rate to be determined in the interbank market on the basis of market forces. We hope it is now clear that the restrictions and surrender requirement that the authorities had tried to enforce earlier are unworkable, and that an orderly exchange market will have to depend almost exclusively on strong domestic economic policies.

In this connection, although the exchange regime is described as a "managed float," we see little scope for exchange rate "management" per se, given Romania's lack of reserves and the expectation of continued exchange rate depreciation, as long as inflation in Romania far exceeds international levels. The possibility of the authorities' engaging in "smoothing operations" seems all very well in theory, but in practice it seems likely that all "intervention" would be on one side of the market, resulting in a constant loss of reserves.

With regard to the external financing situation, the staff's decision to design the program around conservative assumptions about the availability of external financing is well taken; this should minimize at least one potential risk to the program, that of underfinancing. But clearly there are other risks, and in this connection we appreciate the staff's candor about potential risks involved in Romania's capacity to repay the Fund. While these will need to be borne in mind, we believe that Romania has amply demonstrated its commitment to reform and deserves Fund support. Romania's commitment to reform, as well as the unforeseen circumstances that have led to its need to make an early repurchase under the CCFF, also lead us to accept the remarkably front-loaded phasing of this arrangement. However, we feel strongly that phasing such as this must remain the exception in Fund programs--the exception, perhaps, that proves the rule that the Fund never reschedules.

In conclusion, we would like to reiterate our support for Romania's reform efforts under extremely difficult circumstances. We hope, in particular, that they will achieve a significant reduction in inflation and substantial progress on restructuring and privatizing state enterprises that will provide the basis for future growth and employment.

Mr. Wright made the following statement:

Like other speakers, I commend the authorities on their perseverance with this program in extremely difficult circumstances. The focus in the year ahead should be on intensifying the pace of structural reforms to make markets work better. In view of the slippages earlier this year and the imminence of elections in Romania, like Mr. Tabata, I have some misgivings about the level of access, the front-loading of purchases, and the way in which the overdue CCFF repurchase is being refinanced. However, I am broadly satisfied that this stand-by arrangement and the World Bank's structural adjustment loan are supporting an adequately strong program. The prior actions in the areas of exchange and trade liberalization, interest rates, and subsidy reduction are particularly reassuring.

It is essential that the target budget deficit of 2 percent of GDP is not exceeded, given that it is being financed by monetary means. I would, incidentally, be interested to hear in this connection why measures to increase nonbank financing of the deficit have not proceeded as quickly as was intended last year. In the taxation area, I was slightly surprised to see that indexation of the base for property taxes is listed merely as a contingency measure. The authorities should perhaps consider doing this anyway in the current inflationary conditions. The reduction of subsidies, meanwhile, and their replacement by a well-targeted social safety net, has been much slower that originally intended. I welcome the World Bank's conditionality in this area, but there still does not seem to be a firm timetable for phasing out the subsidies to the mining industry.

I welcome the unification of the exchange rate. Romania's reserves are too low to make the adoption of a fixed exchange rate a viable option at the moment and I agree that Romania's experience with an overvalued exchange rate shored up by administrative controls has been an unhappy and unhelpful one. But I was disappointed not to see more recognition that the exchange rate developments can be a useful guide for domestic policy in present circumstances when other economic aggregates remain in considerable disarray. It is important that the flexible exchange rate policy to which the authorities committed does not become a mechanism for validating domestic policy slippages. A tight monetary policy will be of central importance. Even after the recent increase the refinance rate is probably still negative in real terms. The authorities' intention to set real interest rates with respect to expected inflation is appropriate. But the expectations concerned must, of course, be realistic ones.

The program correctly focuses on strengthening financial discipline at the enterprise level. An immediate priority is to ensure that enterprises are under no illusion that there will be a repeat of last December's global compensation scheme. The authorities have submitted to Parliament a draft law imposing strong financial disciplines on enterprises. It is essential that this law is passed soon and the bankruptcy provisions properly enforced.

The authorities' privatization plans are bold. A proportion of the share capital of each state enterprise will be allocated to Private Ownership Funds, the ownership of which will in turn be transferred to the population using vouchers. But 70 percent of the share capital of each enterprise will remain with the State Ownership Fund. I wonder whether the benefits of private ownership can really be expected to emerge with such a high residual state shareholding. I was also unclear whether the management of the Private Ownership Funds will be truly independent and whether their investment strategies and their relations with enterprises will be guided by the need to maximize the yields of their portfolios.

Private sector activity in Romania now accounts for about 20 percent of GDP. This is encouraging. But it appears from the staff report that authorization is still required to set up a business in the private sector. Can the staff reassure me that any licensing requirements that exist do not represent a deterrent to the establishment of private business.

I was slightly disappointed that neither the stand-by arrangement nor the structural adjustment loan specifically addresses problems in the banking system, which must be tackled to ensure effective transmission of monetary policy and to impose hard budget constraints on enterprises. The fact that interest rates hardly changed following their recent liberalization was apparently due to the monopoly position of the Savings Bank. I would be interested to hear what is being done to promote competition in the banking system, ensure that lending decisions are made on a rational commercial basis, and address the problem of nonperforming loans.

On the issue of financing, I would welcome the staff's comments on the very modest pace of disbursement under the World Bank's operations in Romania. Last year the Bank made commitments of $330 million (including a quick-disbursing critical imports loan), but so far only about $10 million of this has been disbursed. This is very worrying in view of the fact that Romania has already suffered a drastic compression of imports due to shortfalls in external finance. It is essential that the authorities address the cause of these disbursement delays urgently.

Finally, Romania's experience with the CCFF points to three aspects of the facility that need to be reconsidered. These questions should more properly have been raised in the work program discussion at EBM/92/66 (5/27/92). I apologize for raising them now, but perhaps the staff could consider them in the context of the review. The first question is whether access under the compensatory element of the CCFF should be more tightly restricted where the calculation is based partly or wholly on estimated data. This would help avoid early repurchases arising from estimating errors.

The second question concerns the unexpected decline in import values that cause Romania's early repurchase obligation. As this chair has pointed out before, changes in import volumes are treated quite differently in the compensatory and contingency elements of the facility. The staff's comments on this issues in a paper earlier this year (EBS/92/23) did not alter my view that combining two different approaches to import volumes within a single facility is anomalous and unjustifiable.

The final issue that deserves to be looked at is whether an early repurchase that is not made within 30 days of notification should be classified as an overdue obligation. I am not looking for answers to these issues today. I hope that the staff will address all these issues in the paper for the Board's review of the CCFF later this year.

I can support the proposed decisions.

Mr. Esdar made the following statement:

I would like to join other speakers in commending the Romanian authorities for the progress achieved so far in transforming the Romanian economy into a market-based system in spite of shortfalls in external assistance and the very difficult economic environment. As has been pointed out by other speakers, the achievements in liberalizing prices and abolishing controls and administrative restrictions within the trade and financial systems are impressive. Encouraging progress has been made in setting up the adequate legal and institutional framework for private ownership. The process of privatization of state-owned entities and state-owned housing is well under way.

While the impressive success in the structural area is welcome, financial stabilization remains an area of major concern. Instruments of monetary policy were misused to accommodate weak financial policies of enterprises. The rate of inflation is much higher than originally envisaged, as monetary aggregates could not be controlled effectively. Therefore, I welcome the program before us, which is aimed at bringing down inflation, strengthening monetary control, and reducing domestic and external imbalances while maintaining and reinforcing the structural transformation and reform process.

As I agree with the thrust of the staff appraisal, I would like to make only a few points of emphasis. First, I should underline the crucial need to establish monetary control and bring down inflation. I especially welcome the intention to introduce indirect methods of monetary control and to move away from bank specific credit ceilings. Maintaining a flexible interest rate structure reflecting market conditions is a precondition for ensuring effective implementation of the revised system. In this regard, establishing positive real interest rates should be given the highest priority. The maintenance of negative real interest rates would undermine the overall stability of the program by stimulating capital flight and discouraging foreign investors, especially given the uncertainties with regard to exchange rate developments.

However, a market-oriented interest rate system can achieve its full effectiveness only if--at the same time--financial markets are developed accordingly and monopoly situations are avoided. Therefore, it is crucial to dismantle monopolies in the banking sector and to improve competition in the savings and deposit market. To overcome this situation by requiring certain banks like the savings bank to pay positive real interest rates may work for a transition period. However, this can certainly not be a lasting solution. I will be interested in the staff's reply to Mrs. Hansen's question in this regard.

To avoid further undue pressure on monetary policy it is critical to improve financial discipline and stability of enterprises. Therefore, I greatly welcome the fact that a law has been submitted to the Parliament which addresses this issue.

Second, with regard to fiscal policy, I share the staff's view that a tight fiscal stance has to remain a cornerstone of the program. The agreed policy course in this area seems to be appropriate. I especially welcome the fact that contingency measures have been agreed upon to ensure that fiscal policy remains on track if deviations should occur. I have noted that new income taxes will be implemented by midyear, and that the authorities intend to introduce a simplified VAT by the beginning of 1993 and a global income tax at the beginning of 1994. Such a comprehensive tax reform program will certainly improve the overall efficiency of the system and strengthen the revenue base. However, as demonstrated by experiences in other countries, such reforms very often require considerable implementation capacity and for a transition period revenue shortfalls due to the structural changes may occur. I would be interested to hear the staff's view on the extent to which Romania is prepared for these reforms institutionally and the extent to which possible revenue shortfalls could be expected.

With regard to the subsidy situation, I agree with the staff's recommendation to reduce consumer subsidies and to phase out enterprise subsidies. That consumer subsidies have already decreased by 25 percent is welcome. However, given the considerable amounts involved, causing severe risks for the budget, I wonder whether a more ambitious time frame could be envisaged.

With regard to pricing and incomes policies, I can endorse the proposal to support monetary and fiscal policy by some form of incomes policy. However, I wonder whether the consumer price indexation of wages might harden inflationary expectations. The intention to keep wage increases below the projected rate of inflation might mitigate the effects. However, I would like to hear the staff's comments on this. With regard to the exchange rate policy, I fully agree with the remarks of Mr. Wright. Indeed, exchange rate flexibility cannot be a substitute for domestic stabilization policies. The balance of payments situation remains rather vulnerable. For the program year, unfinanced financial gaps of $180 million are projected. And for the following years the situation will hardly improve. There remain considerable uncertainties for the years to come, and the staff has come to the conclusion that Romania will face significant risks in achieving medium-term viability. However, given the optimistic assessments with regard to the outcome of the discussions within the Group of 24, I can go along with the proposed decision. Finally, like other speakers, I feel a little bit uneasy about the front-loading of the program, especially in combination with the early repurchase requirement.

I hope that this will be a very exceptional case, and I look forward to hearing the comments on Mr. Wright's proposal to address this issue of early repurchase requirements in connection with the next CCFF review.

Mrs. Martel made the following statement:

I, too, can join other speakers in commending the authorities for the progress already accomplished and the persistent and comprehensive efforts to radically transform the Romanian economy. These efforts have to be pursued and supported by the international community at a crucial point in time. Indeed, the year 1991 has known both some slippages in the macroeconomic indicators, based on the program objectives, as well as the challenging decision called global compensation. Therefore, some lessons can be drawn from these shortfalls, and, specifically, the public enterprise restructuring should be pursued as to enforce the adjustment process.

Let me now add a few comments on the main areas of macroeconomic policy. First, regarding fiscal policy, the authorities decided to sustain a tight approach limiting the deficit to 2 percent of GDP in 1992. This commendable effort is particularly difficult at a time when real GDP is expected to decrease by 5 percent in 1992 (after 13 percent in 1991). However, it would be easier to accomplish if the transfers were reduced. On the contrary, I noted in Table 6, on page 31, that transfers are supposed to increase by 1.3 percent of GDP in 1992. Like other speakers, I would welcome comments from the staff on how they foresee reducing this burden on the budget and on the timing they envisage to have these transfers replaced by a more targeted safety net.

Second, on monetary policy, I would like to address incomes policy and public enterprise restructuring, which have proven to be closely linked. First, I fully endorse limiting the rise in broad money so that it will remain below the price increase. As stated in the report, the so-called global compensation has artificially produced a surge in monetary aggregates, which now has to be somehow compensated. It should be accompanied by a return of income velocity of money to its normal trend.

Second, to prevent a new surge of inter-enterprise arrears, a law on settlement of outstanding payments (Law 80) and some subsequent decisions have been adopted. The enforcement of this new financial discipline, which aims at preventing the buildup of new arrears, has to be closely monitored.

Third, in order to prevent another source of inflation, another main nominal anchor in the authorities' program is the incomes policy. Given the agreement with trade unions on a forward-looking wage indexation scheme, I expect a decline in real wages to be consistent with the deflationary policy.

Finally, on monetary policy, a lot remains to be done to restore real positive interest rates and an efficient financial sector. The shift for the Central Bank from bank-specific credit ceilings to indirect monetary control has to be organized so that competition is introduced in the banking sector and real positive interest rates give incentives to domestic savings. Some steps are described in the report, but a real financial sector reform seems to be urgently needed.

On exchange rate and trade policy, the authorities have set the right targets: unification of the exchange rate and elimination of foreign trade restrictions. Regarding the unification of the exchange rate, I have to reiterate the comments of this chair of last year. Given the lack of international reserves, the free-floating system might be unavoidable in a first stage. After some hesitation, the authorities have come to the same conclusion. I welcome this new attempt at unification and expect, with the building up of reserves that is forecast, that it will be possible in the medium term to secure the benefits of the program by the fixation of a stable exchange rate.

The liberalization of the exchange system is also accompanied by an ambitious trade liberalization. I do welcome this consistent evolution, but I would like some comments from the staff on the decreased trade-weighted average nominal rate of protection. It seems that, although there was an agreement with the GATT on an average tariff at 12 percent, the authorities reduced it to 5 percent for 1992. This clearly affects domestic enterprises and government revenues.

Turning briefly to structural reforms, I would simply support the report's analysis and call upon our sister institution to support strongly and urgently the following actions: prepare and launch a massive program of privatization; replace large transfer and subsidies by a well-targeted safety net; and implement an ambitious financial sector reform.

Finally, I would like to recall that the sustainability of the adjustment package depends on adequate overall financing support.

As stated in the report, the capital inflows fell short of programmed amounts in 1991, which contributed largely to capital shortages. Due to the deflationary policy, the current account deficit will remain limited in the near future and a small financing gap will persist from 1992 to 1997.

Our institution is sustaining its efforts, which are now followed by the World Bank, particularly for 1992 and 1993. This example should be followed by all bilateral creditors with an equitable burden sharing. I therefore urge non-EC G-24 members to demonstrate their support for the Romanian efforts.

I support the proposed decisions and wish the authorities well in their endeavors.

The Executive Directors agreed to continue their discussion in the afternoon.

3. REPUBLIC OF SAN MARINO - APPLICATION FOR MEMBERSHIP

The Chairman informed Executive Directors that the Fund had received an application for membership from the Republic of San Marino.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/92/67 (5/27/92) and EBM/92/68 (5/29/92).

4. AUSTRALIA - 1992 INTERIM ARTICLE IV CONSULTATION

The Fund notes the staff report for the 1992 interim Article IV consultation with Australia (SM/92/101 and Sup. 1) and declares the consultation completed.

Decision No. 10029-(92/68), adopted
May 27, 1992

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/92/13 (5/26/92) is approved.

APPROVED: March 2, 1993

JOSEPH W. LANG
Acting Secretary