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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/13

10:30 a.m., February 20, 1996

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, First Deputy Managing Director
A. D. Ouattara, Deputy Managing Director

Executive Directors	**Alternate Executive Directors**
	O. A. Himani, Temporary
M.-A. Autheman	
E. Srejber	B. Andersen
L. E. Berrizbeitia	V. J. Fernández
I. Clark	
	D. Z. Guti
H. Evans	J. Shields
	H. B. Disanayaka
E. R. Grilli	N. Coumbis
J. E. Ismael	
D. Kaeser	D. Gotz-Kozierkiewicz
A. Kafka	
W. Kiekens	
Y.-M. T. Koissy	H. A. Barro Chambrier
K. Lissakers	B. S. Newman
H. Mesaki	
	M. A. Ahmed, Temporary
C. Saito	
	B. Esdar
A. S. Shaalan	Y. Y. Mohammed
	A. Vernikov, Temporary
	J.-H. Kang
	L. B. J. van Geest,Temporary
	Han M.

L. Van Houtven, Secretary and Counsellor
S. Bhatia, Assistant

Also Present

IBRD: R. Kanbur, Africa Regional Office; N. Kamel, F. Kilby, International Economics Department. African Department: C. Brachet, Deputy Director; J. A. Clément, C. A. François. External Relations Department: P. C. Hole, Deputy Director; P. J. Bradley, A. O. Liuksila. IMF Institute: R. C. Barth. Monetary and Exchange Affairs Department: A. B. Petersen. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, Deputy Director; A. R. Boote, H. W. Bredenkamp, R. M. Brooks, B. Dabrowska, C. Daseking, S V. Dunaway, M. Fisher, C. J. Jarvis, R. F. Krieger, T. Nishizawa, S. M. Nsouli, C. Puckahtikom, D. C. Ross. Research Department: M. S. Khan, Deputy Director; J. Aziz, E. Detragiache, R. D. Haas, P. Wickham. Secretary's Department: W. S. Tseng, Deputy Secretary. Treasurer's Department: D. Gupta, Z. Farhadian-Lorie, V. Treichel. Office of the Managing Director: S. Sugisaki, Special Advisor; J. Quick, Personal Assistant; D. Burton, P. - I. Koupaki; Advisors to Executive Directors: J. M. Abbott, P. A. Akatu, R. F. Cippa, S. S. Farid, T. K. Gaspard, K. M. Heinonen, G. Iradian, J. M. Jones, J. Justiniano, R. Kannan, W. C. Keller, J. C. Martinez Oliva, M. F. Melhem, H. Mori, S. N'guiamba, Y. Patel, M. Petrie. Assistants to Executive Directors: P. I. Botoucharov, K. Byrne, A. G. Cathcart, J. Dagustun, J. C. Estrella, L. Fontaine, S. Fukushima, C. M. Gonzalez, A. Guennewich, J. Hamilius, R. J. Heinbuecher, K. Kpetigo, N. L. Laframboise, D. G. Loevinger, J. Mafararikwa, G. P. Ramdas, A. Ruocco, K. Sakr, Song J.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he had traveled to Israel to participate in a meeting of the member countries in the constituencies of Mr. Wijnholds and Ms. Herfkens, Executive Directors of the Fund and Bank, respectively. The meeting had been hosted by the Bank of Israel and the Ministry of Finance. Of the 12 members in the constituency, nine were transition economies. With the exception of Bosnia and Herzegovina, all the members had been represented by either the finance minister or central bank governor, or both; the Netherlands had also been represented by several ministers and the Executive Directors and the Alternate Executive Directors of the Fund and the Bank.

Michael Bruno, Chief Economist of the World Bank, Ronald Freeman of the European Bank for Reconstruction and Development, and he had made presentations on a variety of subjects, the Deputy Managing Director continued. He had spoken on the world economic outlook, as well as on the economic aspects of the Middle East peace process. Mr. Bruno and Mr. Freeman had emphasized the central role of the financial system in transition economies; Mr. Bruno had presented interesting results from the World Bank's research on transition economies prepared for the new World Development Report. Mr. Freeman had spoken on the practical lessons of conducting business in the transition economies, and, in that context, had stressed the importance of Fund assistance in reforming the tax system in those countries. Mr. Wijnholds had indicated that all the members in his constituency were satisfied with their relations with the Fund.

He had taken the opportunity to meet with the Prime Minister of Israel, the Finance Minister, the Governor of the Bank of Israel, and foreign ministry officials to discuss the economic aspects of the peace process, the Deputy Managing Director continued. The officials had indicated that they were pleased that the date for the elections had been moved forward, as that would have the effect of lowering public spending. The economic situation in other respects was excellent, with inflation declining and growth picking up. However, the balance of payments deficit was quite large.

He had also taken the opportunity to meet with the Fund resident representative in the West Bank and Gaza Strip, Mr. Fayyad, who was working on strengthening ties between the Fund and the Palestinian Authority, the First Deputy Managing Director stated. He had also met with the World Bank resident representative, who was coordinating donor activity in the West Bank and Gaza Strip. Both the Fund and World Bank resident representatives had stressed the importance of continuing to strengthen the Finance Ministry.

2. DEBT SUSTAINABILITY ANALYSIS AND ANALYTICAL ASPECTS OF DEBT PROBLEMS OF HEAVILY INDEBTED POOR COUNTRIES

The Executive Directors considered staff papers, prepared jointly by the staffs of the Fund and the World Bank, on debt sustainability analysis for the heavily indebted poor countries (SM/96/22, 1/31/96), and analytical aspects of the debt problems of those countries (SM/96/23, 1/31/96). They also had before them a letter on the subject, prepared in consultation with the Fund staff, from the Bank's management to its Executive Directors (SM/96/26, 2/1/96).

Mr. Evans made the following statement:

I am grateful to the staff for their helpful papers on this important issue. I will comment on the analysis, which (when considering individual countries) tends to minimize the scale of the problems: and I will suggest how we take this forward so as to give our Ministers viable policy options at the Spring Meetings.

On the analysis, I believe that a debt overhang damages economic performance in the following ways: it deters investment in physical and human capital, because of the implicit tax imposed by heavy debt burdens; it is liable to lead to bad policy decisions in countries which have already suffered from gross economic mismanagement in the past; it creates large elements of uncertainty in an economy: nobody knows how much debt will be serviced in the future and who will pay; it absorbs a disproportionate amount of the very limited administrative resources of government in the lengthy business of debt rescheduling and negotiations of new loans to cover old ones.

These propositions reflect, I believe, sound economic theory. There is also, as the paper brings out, empirical support for these propositions, particularly from middle-income countries. The evidence for the poorest countries is not overwhelming. But we should recall that in the 1980s we--the international community, including the World Bank and the Fund--committed ourselves to substantial debt and debt service reduction, both in the Paris Club for the poorest countries and via the Brady deals for middle-income countries. We made these commitments because we accepted the argument that debt overhang damages economic performance. Rather than wait for conclusive evidence at the 95 percent probability level, we accepted the case for new mechanisms to relieve debt; and the evidence of this decade strongly suggests we were right to do so. The very same arguments that we used in the 1980s for commercial debt owed by middle-income countries and by official debt owed by the poorest countries must also apply to the debts owed by the poorest countries to the multilateral institutions.

As to sustainability, the methodology in the staff papers is to look ahead up to 10 years, on the basis of strong economic reform programs being successfully implemented, and judge the sustainability of the debt ratios after five and ten years. I want to suggest that there are several sources of bias in this approach:

Sustainability is an essentially forward-looking concept; yet the future is increasingly difficult to foresee even in the broadest terms. The moral is that we cannot put all our weight on extremely uncertain projections over ten years: a comprise is to focus on no more than five years ahead.

No allowance has been made in these projections--e.g. of investment, exports, and output--for any damaging effects of debt over-hang. If, as I believe, these effects can be substantial, there is a bias towards minimizing problems.

The projections assume substantially better economic performance policy than in the past decade. While it is absolutely right to insist on strong policy commitments by countries which seek exceptional treatment of their debts, better economic policies may well only be attainable in the context of more debt relief than is assumed in the projections.

The vulnerability of these economies to, for example, commodity price shocks, is covered in the analysis, but not incorporated into the findings. I believe the record shows that shocks are more likely to be adverse than beneficial.

These four sources of bias reinforce my argument that many of these countries will not be able to sustain their debt burdens without additional forms of debt relief. In my view--and this is a view shared by the Fund and the World Bank representatives at the Paris Club--we need to use cautious, rather than optimistic, assumptions about the future, in order to provide a cushion against possible shocks.

In their second paper, the staff comes up with 8 countries in the "unsustainable" category. I believe we need to add to that group the 12 "possibly stressed" countries.

We need to respond, in our search for practical new options, to the clearly difficult position of all those 20 countries which cannot currently--or even looking five years into the future--be classified as "sustainable". Some of these countries already have a good track record of economic reform and should benefit straight away from new options to deal with their multilateral debt. For others, we will need to assess debt sustainability again if and when a track record has been established. In the next stage of our work on developing options, I believe that we may also need to reconsider some of the countries which are currently classified as "sustainable", e.g. as their prospects alter, and less rosy scenarios emerge. And we may need to consider the three countries presently unclassified because of lack of data (Liberia, Somalia, Nigeria). But I would certainly want to focus on the group of 20 countries who are most in need of relief, as assessed in the current analysis, in the first instance.

Concerning eligibility, the papers point out, rightly, that debt relief in the absence of sound economic policies does not work. So a country should qualify for additional debt relief by the multilaterals only if it meets two conditions:

(1) a heavy overall debt burden; and

(2) a track record of sound policies: sometimes this has already been earned; in other cases it will need to be earned in the future.

Putting these two conditions into practice on a case-by-case basis will mean that the number of countries that can and should be helped by additional measures by the IFIs in any one year is likely to be very limited. Thus the costs of additional measures will be moderate.

As regards policy, in the next stage of this exercise staff will identify and evaluate policy options for removing unsustainable debt burdens. I want to suggest some principles on which this should be based:

(1) A country's total debt problems must be dealt with.

(2) At least 20 countries would need to be considered on a case-by-case basis.

(3) The creditors must act in a coordinated way: this does not imply a global facility (which is likely to be impractical) but action in parallel.

(4) Further action on debt must be linked explicitly to good economic management, including a track record, and must lead to a sustainable outcome.

(5) Action by the Fund and the World Bank must preserve their financial integrity, above all the continuing ability of the World Bank to borrow on the finest terms.

(6) Action by the Fund and the World Bank must rely on the Bretton Woods' own resources.

Mr. Koissy made the following statement:

The issue of debt sustainability of heavily indebted poor countries (HIPCs) can be examined from various angles. Despite a number of data-related difficulties, the staff deserves to be commended for completing this study, which analyses the debt situation of these countries and the prospects for some of them to become current on their debt service payments during the next ten years. We recognize that the staff findings are based on a number of assumptions, including the continued and successful implementation of growth-oriented adjustment policies accompanied by a steady expansion of exports, debt restructuring arrangements between the creditor and debtor countries under the terms available in the framework of both the Paris and London Clubs, and the provision of new financing from external sources in order to achieve the economic growth objectives of the countries involved.

However, we feel that, in the absence of a new debt reduction mechanisms including the possibility of debt forgiveness from bilateral official creditors and a major debt reduction initiative from private commercial lenders, the current debt difficulties will remain severe for a large number of the HIPCs. For some of these countries, it may even be necessary to envisage a new approach to the treatment of multilateral debt along the lines already suggested by this Chair during previous meetings.

To find a lasting solution to the ongoing debt crisis, it is important to keep in mind the fact that in the framework of international lending agreements, creditors are expected to fully evaluate the various risks involved in the financing of investment projects and debtor countries take the responsibility of repaying the contracted debt during a specified period. What went wrong in the case of international lending for economic development?

There are many factors that contributed to the present debt situation. In creditor countries, lending institutions did not properly assess the possibility for governments of low-income countries to be unable to service their external debts. Loan commitments to these governments, particularly by bilateral agencies, were often made for political reasons, without sufficient use of "cost-benefit analysis" criteria in the choice of investment projects. As a result, many of the loans granted by these institutions were dubious.

On the basis of the foregoing, there is a need for a "burden-sharing" arrangement between creditors and debtors in order to find a satisfactory solution to the debt problem in a cooperative spirit. In other words, an appropriate mix of domestic adjustment efforts, substantial debt reduction and restructuring, and the provision of fresh money is required.

In debtor countries, it has been widely said that government officials squandered externally borrowed resources on projects with low profitability rates, and adopted macroeconomic policies that undermined their capacity to repay their external debts. In addition, the public sector grew rapidly to levels which have become unmanageable for the majority of these governments. The absence of well developed financial systems is another important factor which led to the heavy dependence of these countries on external financial flows, in the form of grants and loans. What can we learn from the past mistakes in order to enable the HIPCs to adopt more efficient development strategies in the future?

In the framework of the ongoing adjustment programs, the Governments together with the Fund and the World Bank have already recognized the need to create an environment in these countries where private sector activity will play a dominant role. This requires a reform of the public sector and the establishment of strong financial systems.

To avoid the repeat of the current difficulties, specific guidelines should be adopted with regard to budgetary policies. For example, governments should be required to put ceilings on their external borrowing. In addition, the allocation of budgetary resources would have to meet a number of requirements. One possibility is to say that external and domestic public debt service payments should not exceed a given proportion of government budgetary receipts (excluding grants). This requirement is likely to help the HIPCs to avoid debt service payments difficulties in the future.

In discussing the symptoms of the debt crisis, the staff has selected two main indicators for the classification of HIPCs into three categories: "sustainable," "possibly stressed", and "unsustainable" debt burdens. The choice of these indicators does not pose major problems. However, they are not sufficient to provide a clear picture of the magnitude of the debt problems of some HIPCs.

As regards the category "possibly stressed," which includes countries on the borderline, we feel that it does not properly describe the difficulties facing these countries. Using the indicators proposed by the staff, these countries may appear to be able to overcome their debt payments problems in the foreseeable future. However, using other indicators, including ratios to Government revenue, and the primary surplus of the Government budget, one could conclude that their situation is unsustainable.

If one considers the external debt service payments difficulties of these countries as being primarily a "public finance" problem, the indicators should be expressed in terms of government revenue. This is particularly the case for CFA franc zone countries, given the existing arrangements with the French Treasury. In such cases, an analysis of the structure of government current expenditures could help to establish guidelines for the sustainability of the external debt.

Here, the experiences of some countries which have had no external debt payments difficulties in the past, could be useful. The average proportion of their budgetary receipts which is used to service interest payments on external public debt, could constitute a budgetary target for the HIPCs. Such a target would be achieved gradually through a combination of civil service, public enterprise and tax reforms. However, the time horizon for the achievement of this target may vary from country to country.

To achieve the objective of high private sector-led economic growth, incentives are needed in creditor and debtor countries to attract more foreign (direct and portfolio) investment. In creditor countries, special tax incentives could be granted to enterprises which undertake investment projects in HIPCs. At the same time, debtor countries will have to create a favorable environment, including a legal and regulatory framework, for such investment to take place at minimum risk.

Having said the foregoing, it is difficult to support the proposition that the indicators chosen by the staff are sufficient to assess the debt sustainability of all HIPCs. In addition, the time dimension cannot be determined as it depends on the level and the structure of a country's debt, as well as on the strength of adjustment policies implemented by the country.

The Director of the Policy Development and Review Department noted that the Fund representative at the Paris Club had emphasized the importance of ensuring that the Paris Club's Naples terms would enable heavily indebted poor countries to "exit" from the debt rescheduling process. In that context, the staff representative had stressed that a margin--in terms of accumulation of reserves--be built into the debt relief provided under the Naples terms, to enable countries to move forward after debt rescheduling. The staff had not incorporated debt overhang as a separate factor in its projections; however, as the scenarios were based on recent experience, the effects of debt overhang were reflected in them. Indeed, it could be argued that the projections did not account for the positive impact of debt restructuring and debt relief on countries' debt burdens.

Mr. Evans remarked that at the Paris Club and in other forums the representatives of governments and the international community had agreed that the debt burden of heavily indebted poor countries was a problem that needed to be addressed and that an "exit" strategy was needed. In that context, he considered that assumptions should be cautious; for example, the assumptions that Uganda's annual output growth for the next five years would be 6 percent and annual import growth would be 2 percent were rather optimistic, in his view.

Mr. Shaalan made the following statement:

Following the extensive studies of the recent past by the Fund and the Bank of the heavily indebted poor countries, there was reason to believe that there were a number of countries whose debt situation was unsustainable with existing financing mechanisms. The country-specific analysis as well as the analytical aspects paper certainly enrich our knowledge of the problem and as such are a welcome first step in addressing debt sustainability.

Let me briefly address some of the issues raised in the paper. Are the thresholds proposed used by the staff satisfactory to measure debt sustainability? One cannot quarrel with the two ratios used, namely debt service/exports ratio and the debt/exports ratio. In spite of some limitations, they are reasonable and generally accepted measures of the debt burden. Here, I wonder why the staff did not include another important dimension, namely, the debt/GDP ratios. However, the selected threshold ranges involve, as the staff rightly point out, an important judgmental element. For a variety of reasons, I would feel more comfortable with a threshold for the two debt indicators somewhat below the 20-25 percent and the 200-250 percent ranges. I would also subscribe to a longer time horizon, of at least ten years, to arrive at a safe level of debt. These preferences also represent an element of judgment on my part, but a number of reasons present themselves in favor of this choice. First, of course, there is the array of optimistic assumptions underlying the analysis and conclusions. These include an uninterrupted record of policy adjustments contrary to the realities of our experience, the likelihood of these countries facing domestic and external shocks for which they are less equipped than their more developed partners to address, the probability that supply response may well take longer than assumed, and the generally limited administrative capacity which this chair has on many occasions alluded to. Finally, our experience with the Enhanced Structural Adjustment Facility (ESAF) suggests that we have a tendency to underestimate the magnitude of the poor countries' problems and the time it takes to address them. For these reasons, I feel, like Mr. Evans, that we may be underestimating the extent and depth of the debt burden facing these countries.

The study finds that about half of the heavily indebted poor countries either have unsustainable debt levels or are heavily stressed, while the rest are believed to have sustainable levels. I would suggest that the staff take a second look at the sustainability issue giving some judgmental weight to the aforementioned factors, as well as other considerations that may emerge from the discussion today. Far from suggesting a quantification of the unquantifiable, I believe a qualitative assessment that would form an integral part of the staff judgment is called for. These considerations, I hope, will be taken into account when the staff examines more closely the "possibly stressed group," and possibly those that have been labeled as having a sustainable debt situation, to reach a judgment on the debt profile sustainability.

The staff does identify the risks associated with the debt sustainability analysis. I am not sure, or at least the paper does not indicate (unless I have missed it), that these risks have been taken into account in designing an appropriate baseline scenario. Could the staff inform us whether the risks have been taken, and how they were taken into account. With regard to the importance of the risk factors, I would consider the two major risk areas to be export projections materializing and private capital inflows may be exaggerated. Could our past record of projections in these two areas provide us with some guidance?

On the question of debt overhang, the staff concludes on page 4 of the sustainability paper that the evidence of debt overhangs for the heavily indebted low income countries can neither be confirmed nor denied. Later on in the paper (page 16), we are told that the overhangs would be difficult to incorporate in the analysis and therefore are not explicitly taken in the scenarios, thereby disregarding the possibility that debt overhangs may exist. The appropriate response to analytical difficulties is not to ignore them. I believe we need to explore the debt overhang more closely. In this connection, I associate myself with the remarks of Mr. Evans.

The staff cite the debt experience of some middle income Latin American countries in the early 1980s when the Mexico debt crisis broke out. While they do not draw a direct analogy between Argentina, Brazil, and Mexico, there is an undertone of a comparison when it is indicated that not only were the debt levels in these Latin American countries significantly higher than the countries under review today, but they also had suffered a negative transfer of resources in contrast to the indebted poor countries. I believe we must pay due consideration and be mindful of the limitations of these comparisons. Can it be said that the same debt ratios for a middle income and a low income country are equally sustainable or unsustainable? I do not believe so, for the reasons I cited earlier.

I find particularly interesting the issue posed in the staff's last question, namely whether to anticipate potential weaknesses in a country's debt profile and provide additional relief ex ante. This preventive endeavor would be particularly attractive if we were to judge that this ex ante relief increases the possibility of attaining debt burden sustainability earlier than would otherwise be the case or to prevent the ailment from assuming larger proportions. Of course there remains the slippery question, namely, which countries would be eligible for this ex ante assistance?

Finally, while the paper addresses the problem of highly indebted poor countries, we should not lose sight of the fact that the problem does exist for some heavily indebted middle income countries. One such country that fits this category which was discussed in the Board earlier this month is Jordan. At the time, many Directors brought up the problems posed by the heavy indebtedness for which existing debt restructurings do not sufficiently address the problem.

Mr. Autheman made the following statement:

I welcome this joint paper, which I think centers rightly on the real issue, which is the overall debt burden of the poorest countries. It is interesting to note that there is no way to conduct a fruitful analysis on the narrow base of the widely-publicized multilateral debt problem. The main conclusion drawn by these two papers is that we are still left with a major African problem, and that we need to improve our existing instruments to better help the highly indebted poorest African countries within a framework of proper conditionality and on a case-by-case basis.

I have a few comments on the specifics of the two papers. The debt overhang hypothesis looks attractive, but it is very difficult to find solid support for it, and therefore one cannot base any policy on such an assumption. Indeed, we already knew that Bangladesh's growth overhang was a greater constraint than the so-called Peru debt overhang. If the debt overhang theory was right, we will need to find a good explanation to understand the success of Uganda.

I am in agreement with the major finding of the first paper, which is that good economic policy matters more than debt. Therefore, I am a little surprised that, when the staff considers the tradeoff between debt relief and lending through conditionality, the view is expressed that the short-leash conditionality approach has transaction costs, that it can create uncertainty, and that it can impede local ownership. Debt relief may have even higher costs, i.e., direct financial costs through its impact on the rating of multilateral agencies. It could create even greater uncertainty, since, in order to prevent the risk of moral hazard, debt relief should be accompanied by a restriction of access to new lending. I am not aware that there exists an effective way to convince countries to initiate reform programs without conditionality. Therefore, I think that it was, from a rhetorical point of view, necessary to find some shortcomings to conditionality; but it would have been useful to indicate that these shortcomings are not real.

A second comment on this paper relates to paragraph 11 of the summary. The tradeoff between debt reduction and refinancing through conditionality is too narrowly defined. As is rightly said on page 16, "unless strong incentives to pursue appropriate policies are created, additional debt reduction would not bring to an end the highly indebted poor countries' debt problems, but it will simply be followed by more rescheduling and rollovers in the future."

Another aspect which should also be mentioned is the fact that any debt relief scheme by multilateral banks would weaken their standing, increase the cost to other borrowers, and therefore jeopardize one fundamental pillar of our international cooperation.

Taking now the second paper and the issues for discussion in their order, I have the following comments. I am satisfied with the criteria, so long as they are considered useful rules of thumb, in order to help us in our analysis; but they need to be considered with a big grain of caution.

There are some methodological shortcomings I would like to mention. Stock of debt measurement may be misleading. We must always look at the actual debt service burden, and not at the theoretical debt service burden, before relief is granted by bilaterals.

Another aspect in most countries, classified as unsustainable or possibly stressed cases, is that unreconciled claims owed to some non-Paris Club creditors may be a significant part of the stock of debt. We know that when an agreement is reached the size of such claim will be sharply reduced.

I agree that timing is an important issue to assess sustainability. Indeed, with a time frame of 15 years, which is a reasonably conservative approach, given the situation of the poorest African countries, all countries reviewed by the staff, except Sudan, would achieve a debt-service-to-export ratio lower than 25 percent, provided that they continued to implement appropriate policies.

There are many risk factors, as mentioned by Mr. Shaalan. They cannot be generalized. I think that they call for a case-by-case approach. Each country is faced with specific risks which differ from one to another.

As for weaknesses in the scenarios, the main one is not related to our limited capacity to forecast or take into account all economic aspects of the problem. It is in the capacity of countries to sustain strong policies throughout time; and that is why we have no other choice than to rely on conditionality. We cannot be fully confident that the present strategy will succeed, i.e., that all countries will maintain a cooperative approach with international institutions. Both debtor and creditor countries may be attracted by other options, but I do not consider that there is a serious alternative to conditionality.

Since this is the first step of a more ambitious exercise, I would like to make a few concluding remarks.

One of the reasons why we are invited to address the so-called multilateral debt problem is that we would be short of instruments and that the decline in official development assistance calls for a new approach. I would just like to list several existing instruments which we can improve in order to assist highly indebted poorest African countries without changing our overall strategy.

The only one which is of relevance for this institution is, of course, the permanent ESAF, which would guarantee that we would be able to assist the countries throughout time. Another is to increase the share of multilateral official development assistance, which benefits the poorest countries. It should be better known that less than 40 percent of IDA goes to Africa, and within this 40 percent, less than the total goes to the support of the highly indebted poorest countries. So, whatever the total amount of IDA, there is a big margin for improvement by increasing the share of the countries which we have identified as the ones which must benefit from our greater support. Bilaterals can do more. They have only begun to implement the Naples terms. Some bilaterals can contribute to the problem by settling non-Paris Club claims in a reasonable fashion.

Finally, I would like to show to my colleagues a table from the last World Debt Tables document which shows that, if half of official development assistance goes to low income countries with very wide donor variations, heavily indebted poor countries receive only 30 percent of total official development assistance, here again with very wide variations.

Mr. Evans noted that there was considerable evidence that debt overhang adversely affected economic performance of indebted countries. That had been recognized by the international financial community in the past, including the Fund, when it had agreed to a number of debt initiatives, such as the debt equity "swaps," the Brady plan for the middle income countries, the IDA Debt Reduction Facility, and the debt reduction Naples terms of the Paris Club. Also, the economic performance of those countries, following the debt initiatives, corroborated the view that debt relief had a beneficial impact.

Mr. Berrizbeitia remarked that the debt problems were not confined to sub-Saharan Africa.

Mr. Ismael made the following statement:

Having made explorations in possible future international debt adjustments last Friday, the Board is now posed for an equally tough exercise to consider the analytical aspects of the debt problem.

I will try to offer practical comments and confine myself to the following four aspects: (1) assessment of debt sustainability; (2) the debt overhang theory; (3) the short leash approach; and (4) the methodology/criteria of debt sustainability.

An in-depth discussion on debt sustainability should be considered as one of the most crucial issues. Discussions of this issue have, in general, tended to be biased by both official and private creditors because of interference of other considerations; in particular, the fear of creating a precedent of giving more appropriate terms to a specific country's needs that would, at the same time, appear more favorable than those obtained by some other countries. The fact that some countries are categorized the same way by multilateral institutions/G7 does not necessarily mean that they can bear the same terms of debt treatment.

In addition, the assessment of "debt sustainability" should be, above all, realistic. As part of negotiating tactics and also to help adjustment programs obtain necessary support, sometimes overly optimistic assumptions have been used to build medium-term outlooks. The staff, in their papers, recognized that projections are difficult to make, especially for those countries which are highly dependent on a few commodity prices. It would, therefore, be preferable to allow for "safety margins" in assessing debt sustainability.

Regarding debt overhang theory, I would strongly back all arguments that would support the search for once-and-for-all solutions to the debt problems of the HIPCs. These countries are already in a weak position in worldwide competition for capital and investment. It is particularly vital that they are helped in creating positive assessment from both domestic and foreign investors. This is particularly difficult if people feel that an unresolved recurrent debt problem leads to a permanently fragile financial position, exposing national and foreign investors and lenders to adverse changes in key variables, such as the tax regime, foreign exchange policies, and controls affecting capital and dividend transfers.

The short leash approach has been mainly based on the argument that creditors should be able to use debt relief as a means of maintaining pressure and control on rescheduled countries as regards the timely implementation of their adjustment policies. In addition, creditors have not been willing to give up their rights to be repaid according to the original contracts too quickly if the financial position of the debtor were to improve quicker than expected.

There have been long debates over the years on the pros and cons of this approach, it is nowadays widely recognized that there are much more drawbacks than advantages in such an approach, and they are fairly listed in the papers. One of the most important points, again, is that everything must be done to reduce uncertainty in order to attract private investments and the related potential transfer of know-how in these countries.

It is interesting to note that, in this respect, the commercial banks have been much quicker than official creditors to agree to deal on the stock of debt rather than on "windows" of consolidation.

The "moral hazard" argument is certainly valid, but there are means other than step-by-step debt restructuring to control the economic management of rescheduled countries. This is, in particular, appropriate in the case of HIPCs which will have a continuous long-term need for multilateral and bilateral support.

On the methodology/criteria of debt sustainability, from what I know, the debt service ratios utilized in the papers are widely accepted by the markets and one can argue whether the proper thresholds should be 20 or 25 percent for service and 200 or 250 percent for stock. But, as I have pointed out earlier in my intervention (point 2), the real question should concern the assumptions made to calculate these ratios. They should be totally realistic in projecting the various items in both the current and capital accounts of the balance of payments.

The analysis in the papers is, in my opinion, mainly based on the balance of payments. In most, if not all of the HIPCs, budget problems are at least as serious as balance of payments problems. Therefore, the debt service ratio to budget receipts, should also be taken into account. Obviously, this ratio should also include the domestic debt service burden. Finally, a realistic assessment should be done on a sustainable split between debt service expenditure and other expenditures in the budget.

Mr. Clark made the following statement:

I think that this round of staff papers has significantly advanced our understanding by explaining the methodology and introducing sensitivity scenarios with different assumptions, and by reviewing the theoretical and empirical experience on debt ratios and the secondary effects of debt such as overhang and crowding out.

For me, the papers confirms this chair's previously-expressed views about the existence of a serious debt burden in a group of poor countries. And I think I read the same papers as Mr. Autheman.

Briefly, on the analysis, I have a few comments:

The staff assumptions form a good working basis from which to proceed. On the technical side, it is worth noting that there are many issues that could produce different numbers, such as the use of a different discount rate, or including post-cut off date debt - which is significant for a handful of the low-income countries.

In addition, the assumption on future increases in private investment is optimistic given the undeveloped state of the private sector and the relatively poor environment for investment in most low income countries. While I do think staff have presented a meaningful and acceptable scenario, they recognize that the overall package of assumptions paints a fairly optimistic picture. In this respect, I would tend to agree with Mr. Evans that the group of 12 "stressed" countries should continue to be considered on a case-by-case basis along with the 8 "unsustainable."

From the analysis on debt overhang and crowding out, I would note that debt relief in poor countries may lead to an increase in consumption and little increase in investment. This would imply that crowding out is the dominant channel through which excessive indebtedness hinders growth. I would appreciate staff's comments on this matter - it could have implications for how debt relief is undertaken.

In this sense, any policies to relieve the debt burden will need to ensure that resources freed up from debt relief are channeled into productive expenditures. I certainly agree with Mr. Autheman and the staff that sound economic policy is a sine qua now for any solution.

As to policy/issues to ponder, in terms of future policy direction, I fully endorse all of the six points put forth by Mr. Evans, particularly the third, fourth and sixth. I think these principles form a solid basis from which we must proceed. However, agreeing on the facts was the easy part - the hard part will be to arrive at an agreed solution..

In this respect my own Authorities are now considering the best course of action. They are open to different possibilities and very much encourage debate and further exploration of the matter. In this regard they look forward to the next joint staff paper. However, as Mr. Evans states, my authorities believe that future action by the multilateral institutions has to come from their own resources.

In this respect, I would like to provide you with some food for thought while we contemplate the difficult policy challenge posed by these unsustainable cases.

Let me close with a broad philosophical question about the nature of the Fund's responsibilities.

I start with the observation that I think this Board agrees, or is close to achieving consensus, on the fact that there is a debt sustainability problem for a number of countries. The question is what responsibility, if any, the Fund has toward finding and contributing to a solution.

If this Board admits there is a debt sustainability problem for a subgroup of members, then are we not acknowledging that in the past, the Fund has made some bad loans and has contributed to this problem?

This leads to the moral question. If we decide to let the World Bank and/or other creditors propose a solution, and bear the cost--which is something that has been stated or implied before in this Board--would we not have to acknowledge that the Fund would be free-riding?

It is true that the Fund is not a development institution in the pure sense and is therefore perhaps less suited to debt relief. However, I would note that commercial banks are not development institutions but were forced in the 1980s to undertake debt reduction in order to cut their losses and reinforce their balance sheets. This led to several years of poor earnings for these banks and their shareholders. In this respect, if the Fund really is a financial institution, should we allow it to rely on others in the form of capital infusions from shareholders and debt reduction by others to improve the quality of our own balance sheet?

Mr. Esdar made the following statement:

I can be brief because I think the position of this chair is well known, and I think we have not changed it very much after having read this paper.

I very much welcome the staff papers on debt issues for heavily indebted poor countries. I especially welcome the fact that for the first time detailed case-by-case studies were included for at least some of the countries in question. I would expect that for the remaining countries a country analysis will be provided in the context of Article IV or program papers. It is apparent from the document that any conclusions drawn for those countries where detailed case-by-case studies do not yet exist would be premature. I will therefore focus most of my remarks on those 23 countries for which detailed analysis is available.

I draw the following conclusion from the staff's very helpful presentation. First, there is no general debt problem, much less a general debt crisis, and, in addition, it makes no sense to single out special types of debt for special institutions.

The staff's papers in this regard are very convincing, and I would like to strongly reject the finding of Mr. Evans that there might be a bias toward minimizing the problems in the staff paper. The projections, for example, seem to be very reasonable, and the policy requirements assumed under those projections have to be regarded as minimum requirements in order to allow the Fund to provide its own resources. We cannot weaken our own conditionality by applying weaker policy options in our assumptions. We have to keep this central fact in mind during our discussion on whether additional measures may be warranted in single cases.

Second, the four or eight countries the staff identifies as probably having unsustainable debt burdens will each require a hand-tailored approach to their problems. Since such a discussion would have to be very detailed and intense, I do not want to dwell on that today. It suffices to say that we certainly could not support inappropriate policies in those cases, and, if there are doubts about good governance or doubts about whether the authorities are fully committed to stability-oriented reforms, there can certainly be no solutions.

Third, all the other countries looked at in detail by the staff should reach debt sustainability within a reasonable time frame if policy implementation and reform efforts are strong and the existing very generous debt instruments are utilized flexibly.

Fourth, some of the countries have been included in the category of "possibly stressed" because of fiscal problems. We would reject this view. Fiscal problems do not constitute a reason for foreign debt relief. It is obvious that fiscal and balance of payments problems have some economic interconnections, as do all other economic variables. The failure to sufficiently tap domestic revenue sources to cover domestic expenditures, however, is not an acceptable reason for us to consider debt relief.

Fifth, I was not surprised by the conclusion of the analytical paper that it might not be possible to identify a debt overhang. The well-known and differentiated theories on crowding out cover that terrain very well. The empirical case study, as the staff clearly shows, of debt per se suppressing economic development is extremely weak, even nonexistent. We therefore strongly believe in the benefits of controlling moral hazard through the short-leash approach of conditionality in the context of ongoing rescheduling and refinancing, where necessary, in contrast to explicit debt reduction beyond currently available mechanisms. With regard to Mr. Evans's point that this debt overhang was mentioned in the past, that is true, but I think we all have to live with the experience that arguments are sometimes used, especially at the political level, even if there is no convincing theory behind them.

Sixth, to sum up, we feel that the current already very generous set of debt instruments are fully able to cover the debt problems of highly indebted poor countries. We are aware of very difficult cases where solutions will have to be found on a case-by-case basis when the time is right. That means when it is certain that the Fund and other creditors are dealing with reform-minded and stability-oriented authorities.

We are also glad to note that the Fund's lending has not contributed to--to answer Mr. Clark's point--and will hopefully will not contribute in the future to the debt burdens of most of the member countries. We want to be absolutely clear that we will oppose any use of Fund resources to bail out other less prudent multilateral lenders.

Mrs. Guti made the following statement:

I would like to thank the staff for the comprehensive analysis contained in the two papers. However, I must say at the outset that I think that the basic message tends to downplay the magnitude of the problem. The fact that we are still discussing the debt problem some 14 years after it first erupted as an issue of international concern is partly due to past tendencies of relying on optimistic assumptions which inevitably led to optimistic conclusions regarding the ability of poor countries to service their debt. We believe that past experience suggests that we should err on the side of caution given the nature of the economies under consideration. Considering the external sector, the HIPCs are indeed vulnerable to adverse trade shocks as reflected in the secular decline in the terms of trade of primary producing countries. This has not been given due weight in assessing the potential of these countries' capacity to repay their debt. Furthermore, as noted by Mr. Koissy, using other indicators such as ratios to government revenue and the primary surplus could change the position of certain countries that have been characterized as "possibly stressed" to that of being unsustainable. What this shows is that the ability to service the debt is not simply related to external performance, but must also be seen as a fiscal burden which might compromise the implementation of the countries' adjustment program.

There should be no doubt that a debt overhang severely affects economic performance. The Fund and the Bank should have a wealth of knowledge on the issue given their extensive involvement in a broad spectrum of both middle-and-low income countries. I therefore believe that this should not be an issue for debate at this stage. What is at play is a combination of many factors: the taxing away and the crowding out of investment and growth, the costs associated with low confidence in these countries and the high administrative costs and uncertainties that comes with successive debt renegotiations and restructurings.

The question is whether current debt relief initiatives are sufficient. We feel that the current strategy needs to be enhanced with emphasis on debt forgiveness for the severely indebted poor countries. The objective would be to support strong adjustment measures aimed at sustained growth with export promotion in order to maximize the country's long-term repayment capacity. Furthermore, some of the countries under review may need a new approach to reducing the multilateral debt burden which is becoming a higher proportion of total debt.

Regarding the time dimension for debt sustainability, the suggested period of 10 years is far too long and is not compatible with the design of Fund programs under which external viability is preferred sooner that later. A strategy that delays the benefits of adjustment for too long is likely to bring in adjustment fatigue and raises questions about the ownership of the program. Besides, projecting that long into the future creates more uncertainty about the assumptions on key variables like economic activity in general export growth, terms of trade, revenue performance and natural calamities to which many of these countries are prone.

To sum up, we believe that the debt problem must be approached in a comprehensive manner involving strong adjustment, and debt reduction, emphasizing debt forgiveness for the critical cases, and new concessional financing.

Mr. Mesaki made the following statement:

At the outset, I would like to commend the staff for this detailed analysis. The jointly prepared paper is useful as a basis for discussion of this issue.

First, on the analytical aspect of the report, the staff points out that there is no straightforward way to divide the heavily indebted poor countries into those that have a sustainable debt position and those that do not; there is a considerable judgmental element involved. I think it is in appropriate to judge debt sustainability mechanically based on only one or two criteria.

The staff has taken a two-step approach in the staff paper: first, countries were categorized according to two criteria, and then a close examination was made of countries whose debt position is on the borderline between unsustainable and possibly stressed, with various risk factors taken into account. In my view that approach seems practical and appropriate in view of the constraints of data availability and reliable studies on this issue.

Regarding the paper's assumptions, I share the staff's view that we should take the "best policy approach." I note that, from the standpoint of moral hazard, the scope of the debt problem should be restricted to cases in which a country that is adhering to sound adjustment policies has not been able to improve its debt position within a reasonable time period.

On the results of the analysis, I think the resulting grouping is broadly appropriate, and I expect a detailed analysis of the remaining countries to be done soon. The fact that Zambia was placed in the "unsustainable" category deepens the concern we expressed at the Board meeting on Zambia last year. I would reiterate that measures to strengthen protection for current ESAF Trust resources should be considered in the context of discussion on the successor ESAF.

In my view, one of the most important findings of this analysis is that the composition of debt owed by each country varies widely in terms of lender country.

The fact that there is a variety of creditors shows that we should pursue a case-by-case approach, taking each country's particular situation into account, rather than consider a new mechanism that would target a broad group of heavily-indebted poor countries. I also note that the Fund's claims constitute a small share of total debt in most cases.

As the question of whether any new measures are required to deal with the heavily indebted poor countries' debt problem will be discussed fully at the next Board meeting, at this stage I will limit myself to some brief comments.

First, as the Fund's Executive Board, we should discuss this issue from the viewpoint of whether the Fund needs to take an approach, and we should focus on those countries that have debt to the Fund. We should not explore any measures that would use Fund resources to relieve countries' debt burden to other multilateral institutions.

Second, judging from the results of this analysis, there are only a limited number of countries whose debt burden would be significantly affected by any measure that the Fund might take. Moreover, some countries in arrears, such as Sudan, are included in this number. I would like to emphasize that any consideration of debt relief for countries in arrears would undermine the effectiveness of our current arrears strategy and is inappropriate.

We should therefore narrow our focus to problematic countries that are not now in arrears to the Fund, and whose debt to the Fund constitutes a large part of their total debt. Any consideration of possible measures based on a case-by-case approach should be limited to such countries. In order to define the range of countries that we should consider, the detailed analysis must be completed.

Also, I would like to underscore that we should avoid any measures that could undermine the creditworthiness of the Fund as a monetary institution.

I also believe that the role of the Fund, in terms of both the monitoring and implementing of heavily indebted poor countries' debt management and appropriate economic and structural adjustment programs, will be very important under a case-by-case approach.

Finally, I would like to touch upon the issue of the current ESAF. The situation at present proves that lending policy under the current ESAF is generally prudent, and I commend it. Any deterioration in this prudent policy, however, will lead to frequent occurrences of countries getting offtrack during ESAF-supported programs, and as a result the initiation of a self-sustained ESAF will be undermined.

Mrs. van Geest made the following statement:

I would like to start by thanking the staff for its commendable effort over the last half-year to come up with detailed analyses for 23 of the 41 heavily indebted poor countries and some rough indications for the remainder. I would also like to congratulate the staff of the Fund and the World Bank for what may be the first substantial joint product prepared for the Boards.

On defining sustainability, in broad outline, I can agree with the approach adopted. The reference values of 20 percent of exports for the debt service and 200 percent for the debt level seem useful rules of thumb, while the five- and ten-year benchmarks to categorize countries would seem appropriate as well. However, a debt sustainability analysis is not an exact science, thus leaving ample room for discussion.

First of all, the staff approaches the sustainability problem mainly as an external viability issue. As such, it does not do justice to the fact that the problem also has a budgetary dimension. While the staff presents this as a risk factor, I would argue for a more equal footing of both issues.

Secondly, the staff adopts a "best policies" approach in its calculations. I agree with the staff that such an approach is useful to identify the cases that are unsustainable beyond any reasonable doubt. However, one cannot draw the conclusion that the others are not unsustainable. Of the 23 investigated cases, only 3 are characterized by good and 6 by satisfactory policy performance. It does not seem realistic to expect an immediate change in policies, as obstacles to adopt sound policies will not be removed all at once; new initiatives to adopt such policies also need time to take effect, as the experience with the Naples terms illustrate. It might therefore be interesting to find out how sensitive the results are to this "best policies" assumption. After all, the aim of the exercise is "to assess whether a country is able in all likelihood to meet its current and future external obligations."

Thirdly, as the staff acknowledges, the extent to which supply responds to policies is open to wide margins of error. This would caution against too stringent an application of the 20 percent and 200 percent thresholds on the basis of a central scenario.

As to policy implications, the analysis leads to the conclusion that debt sustainability is a problem for some countries, even after allowing for full debt relief by private and official bilateral creditors. Empirical evidence on the negative effects of high indebtedness on investment and growth is not strong, but with Mr Evans I agree we need not wait until we get conclusive evidence at the 95 percent confidence level.

And whether we like it or not, debt problems of member countries also become problems for the multilateral institutions themselves. The risk of arrears increases, the pressure to extend new loans grows, and that could undermine conditionality. Moreover, the need to refinance could result in inappropriate allocation of resources in the case of multilateral development banks and, more importantly, divert their attention from tackling development issues to dealing with financial crises.

A new approach to the multilateral debt problem is necessary for those countries that are determined to have an unsustainable debt. The debt problem should be analyzed in a comprehensive framework. A coordinated approach with participation of all creditors, including all multinational institutions, is required so as to ensure that the combined effort is sufficient to create a perspective for debt sustainability.

Explicit and systematic multilateral debt-service alleviation could be part of such an approach. Consider first the benefits of debt alleviation. It would diminish uncertainty about future funding and the associated permanent sense of crisis and inadequate possibilities for economic planning in the countries concerned. It will also help to prevent the misallocation of resources in multilateral development banks, I alluded to earlier.

On the other hand, debt alleviation, or reduction, carries costs and risks as well, and it is therefore essential that the design of any new approach addresses these risks. The moral hazard risk brings in a new uncertainty, i.e., the uncertainty whether adequate adjustment policies will be followed by the countries in question, plus the risks that other countries will allow policy slippages in the hope of benefiting from relief as well. Maintaining the soundness of the Fund's monetary character, and the Bank's ability to borrow on Mr. Evans's "finest terms" will also require some mechanism to offset the above risks. The staff paper captures the spirit of these concerns in the notion of a "short leash" but it does not yet provide the concrete design details. It is early days in this process, but presumably the next rounds of preparation will attempt to move to concrete design, and stating a few principles for this purpose is useful. We can agree with a number of principles stated by Mr. Evans, but not with all of them. We do not think at least 20 countries is a principle, but a judgment, and sole reliance on Bretton Wood resources is a position. We would give great importance to the linkage of debt alleviation and track record, as well as preservation of the financial integrity of the Fund and the Bank. I might add another principle to the list: the need for a mechanism whereby the level of assistance is positively related to the strength of the track record and its duration. Thus, rather than an up-front reduction as per need, one might consider an up-front conditioned commitment to reduction.

Eligibility for this type of debt alleviation should be based on clear and objective criteria. The present attempt at defining sustainability is helpful in this respect. Conditionality is obviously another element.

Finally, with Mr. Evans, I think that the creditors should act in a coordinated way by action in parallel. As I stated earlier, high indebtedness does affect the multilateral institutions, but not always in completely the same way. The character and the missions of the institutions differ and their contribution to the debt solution should be tailored to these differences.

Mr. Esdar noted that the staff had assumed that the countries would pursue sound macroeconomic policies.

Ms. Srejber made the following statement:

I welcome the staff papers and the calculations staff has made, and broadly agree on their estimations as well as on the main conclusions. The staff really has earned a compliment for the large amount of work done and for presenting the whole complex information in a digestible way. The documents before us today are particularly good.

Let me start with some general remarks, before turning to the issues for discussion.

The analysis indicates that the debt problem is not general, but exists for a limited number of countries. This conclusion was possible to draw from the earlier stylized scenarios, but the country studies made of course give a more certain ground for this conclusion, at least as certain one can be when dealing with the future. Of the 41 countries analyzed in more or less detail, eight countries are likely to remain with an unsustainable debt situation even after five to ten years of sound policies. A majority of the 41 countries have or are expected to have in some years to have a sustainable debt situation. The 12 possibly stressed countries could also achieve sustainable debt situation, but several of them would have an unsustainable debt situation if the underlying assumptions about for example private capital and/or aid flows would not reach the levels assumed in the projections. Thus, the number of eight countries with an unsustainable debt situation may be revised upwards.

Looking at the composition by creditor of the external debt for these countries and their economic situation in general the staff papers show that both the composition of the debt and the underlying economic factors vary considerably across countries. Debt to non Paris Club official bilateral creditors has a high or a very high share of total debt for half of these countries. Debt to private creditors has a large share in some countries. Debt to multilaterals (debt to the Fund included) does not make up more than 19 percent of the total debt, although it varies among countries with debt to IDA being a large share of total debt for some countries and noticeably debt to the Fund constituting a small share of total debt for most countries.

As Mr. Evans points out in his statement, the so-called debt overhang has been used as an argument in several debt reduction initiatives, including the Brady Plan and within the Paris Club with the Naples terms. However, as the staff paper shows in an interesting overview of theory and empirical studies, negative effects of debt overhangs can neither be confirmed nor denied at the present state of knowledge.

Given that the empirical studies mostly do not distinguish between overhang and crowding out effects and also mostly relates to middle income countries and that furthermore both the composition by creditor of the external debt and the underlying economic factors vary considerably among the countries discussed today, it is essential that the solutions to their debt problems be tailored to the specific country conditions prevailing in a case by case approach.

Since there are difficulties in assessing the debt problem in general, as the staff paper on analytical aspects shows, some assumptions have to be made in the analysis. Many assumptions are uncertain and there are many risk factors, but on balance I think the staff's approach is a good starting point.

Let me now turn to the issues for discussion.

I am satisfied with the criteria and the threshold ranges used for judging debt sustainability. A higher figure than the range 20-25 percent for the debt service ratio to exports would be unreasonable in view of the uncertainties and risks involved in the projections.

In many cases it will take considerable time before a sustainable debt situation is achieved and in a number of countries it is unreasonable to expect drastic changes in the debt situation in a shorter time than 10 years. The problem is that projections for long periods become increasingly uncertain. Thus, a time horizon around 5 years seems to be preferable.

There are many risk factors and I consider the staff's approach useful as a basis for further discussion.

The categorization of countries in three groups is also useful for the further discussion. It is valuable to have the category of "possibly stressed" countries given the uncertainty of the many assumptions and the many risk factors.

The assumptions are acceptable as a starting point for the analysis. There does not seem to be any general bias with regard to the country scenarios.

It can be expected that sound, strong and sustained economic policies lead to positive economic developments and increased inflows of private capital but from a very low level. However, as experience shows us there can be a time-lag between the implementation of sound policies and the response in form of private flows, especially as comes to investments, when investors evaluate whether the adopted policies form a consistent pattern or not and whether they will be sustained. Even if this is not always the case, as shown by for example Uganda, I am inclined to believe that private flows in many cases would probably be relatively minor in volume for many of these countries in the medium-term. And while mentioning Uganda, I would like to quote the Managing Director's recent speech in Paris (January 19, 1996) where he quoted President Museveni of Uganda who as the secret behind his country's success in macroeconomic stabilization said: "First, eliminate inflation! Second, eliminate inflation!" As the Managing Director also mentioned in his speech not only macroeconomic stabilization is necessary though, but in addition an institutional frame work in which investors--both domestic and foreign--have confidence to invest and a positive perception of the Government's role in the economy, is essential. Given that both macroeconomic stabilization and a general framework conclusive for investment has to be in place and perceived to be so on a sustainable basis, the internal supply response to economic reforms may take longer than expected.

Finally, on the assumptions used, I would like to point to that, in the present environment of budget consolidation in the industrialized countries one cannot exclude that the assumption on ODA could be on the optimistic side. However, to sum up according to my view the assumptions are acceptable as a basis for further discussion.

In issue number 6 for discussion the staff raises the general question of whether one should in some cases anticipate potential weakness and provide additional relief ex ante or to support the country under current mechanisms in the context of adjustment programs. How one looks upon this depends to a large degree on the perceived relevance of the debt overhang theory. As the theoretical and empirical evidence is inconclusive we have moved into the realm of what we believe and some might like Mr. Evans choose to believe that a debt overhang damages economic performance whilst others would not be so sure. The issue is then if there are circumstances when the debt overhang theory is particularly applicable to a country. I would, given the present state of knowledge, not exclude that this can be the case. But in cases where ex ante support would be deemed to be particularly important, there should be an established track record and/or up front policy actions. However, as I, as Mr. Autheman, believe that good policies are the most important, in general I prefer support under current mechanisms as this involves stronger conditionality than support ex ante.

Turning then to Fund-specific views, I think the main issue to be discussed in this Board as concerns the Fund's support to HIPC is the magnitude of these countries' debt to the Fund and the role of the Fund as a monetary institution in alleviation of the problem in light of our mandate from the Interim Committee. As comes to the Fund I think that the current mechanisms are sufficient for dealing with the issue, and that if a country strongly adjusts, its effort could be supported by the Fund's concessional instrument--the ESAF. Prolongation of the ESAF-arrangement, of an appropriate size, would play a useful role in giving concessional assistance to member countries combined with appropriate economic policies. A further concessional lending or even debt forgiveness on behalf of the Fund is not in line with the monetary character of the Fund. When supporting an adjusting country it is essential that the Fund and the Bank operate in tandem. Such an approach would probably also be more effective in catalyzing financing.

Mr. Grilli made the following statement:

The issue of debt sustainability for the heavily indebted poor countries is addressed, in the two papers before us, with the attention that this highly sensitive problem deserves. The survey of the methodological and conceptual aspects included in the first paper is useful as a premise and a complement to the detailed country analyses contained in the second paper.

While the big effort underlying the detailed single-country analyses, so far carried out for 23 countries, is apparent, the impression remains that the papers' assessment of the prospects for debt sustainability still remains more illustrative than definitive. The subject is a particularly difficult one, with a large number of factors affecting the trajectory of debt reduction, whose future evolution is hard to foresee.

Still, I believe that the staff's effort is in the right direction. The improvement vis-a-vis past analyses conducted by the staff, based on aggregate measurements of the burden of multilateral debt, is to be acknowledged and appreciated. The refinement is sizable, toward a comprehensive approach which takes explicitly into account country-specific factors and also a wide range of indicators aimed at a more precise and credible assessment of the long-term debt projections.

The first consideration after reviewing the papers is that the debt problem is likely to remain in place over the next five to ten years. Its size should nonetheless become more manageable: only 4 out of the 23 heavily indebted poor countries analyzed in detail are deemed to have unsustainable debt burdens; if one considers the whole group, including those countries which are still to be analyzed thoroughly, the "unsustainable" cases comprise 8 out of the 41 countries. Of these eight countries, two are small (Guinea Bissau and Sao Tome) and two are nearly untreatable cases (Sudan and Zaire). We are left with four significant countries for discussions and projects. In this regard, a numerical assessment of the relative weight of these countries in the whole group, in terms of income, debt, or other macroeconomic variables, might provide helpful insight as to the future dimension of the problem.

On the whole, one is left with the fairly solid conclusion that there is no systemic problem at hand. Nonetheless, a number (small as far as we can tell) of cases exists where debt sustainability is a serious issue to be dealt with on a priority basis. If the 12 "possibly stressed" countries are considered, the situation becomes more nuanced. If one sticks to the basic rationale of the exercise, which is to try to find out whether a country that is persevering along the adjustment route can look forward to sufficient growth and debt reduction, the answer in itself is satisfactory. If the assumption of policy perseverance in the countries involved is relaxed, then the scenario for the future presumably turns out to be much gloomier and little improvement is recorded in comparison with the present situation. The vulnerability indicators in Table 5 of the second paper are very illustrative in this respect: in the group of 13 "sustainable" cases, only one scores a "good" in the criterion of "recent policy performance"; the rest of the cases include five "satisfactory," six "uneven," and one "poor." Policy performance is currently a problem in many of the countries considered and is also apparent from the rest of the country analysis (for example, the paragraph "Specific country cases . . . " on page 11). But, this is indeed also the problem. Policy deficiencies are main reasons for debt unsustainability.

Thus, sound policies and sound policy implementation clearly appear to be strongly necessary, although perhaps not always sufficient, condition for debt reduction in the medium term. In this context, conditionality remains the most important way that we have to ensure that countries establish the appropriate track record of sound policies and at the same time reduce the problem of moral hazard arising from a perceived relaxation of creditors' prudent attitudes vis-a-vis bad policies. I wish to add that Bank and Fund technical assistance and policy advice can also prove crucial in favoring sound policy implementation in heavily indebted poor countries.

In this regard, while agreeing on the costs of Bank and Fund constant monitoring of policy performance correctly listed in the papers (uncertainty, transaction, and loss of ownership), still the advantages of a potential creation of a virtuous circle of self-sustaining macropolicies are overwhelming. The papers' conclusion is absolutely convincing that unless strong incentives to pursue appropriate policies are created, additional debt reduction would not bring an end to the HIPCs' debt problems, but would simply followed by more and more rescheduling and roll-overs in the future. This is the outcome to be avoided at all costs.

On the contrary, if one assumes that the appropriate policy setting will be implemented in all countries, or in the vast majority of them, the picture of single country perspectives, as depicted in the staff document, appears favorable in most cases.

It is worth noting that the staff projections are based on realistic assumptions on the general trends in the supply of development assistance and private capital. This is in line with recent tendencies of concessional lending, constrained by the increasingly limited ability of industrial countries to contribute, in the face of their policies of budgetary consolidation. Nonetheless, in the staff analysis, an increasing contribution from private sector investment is expected to offset the declining trend, in real terms (and, in some cases, even in nominal terms), of the flow of grants and concessional lending. This suggests that, in the presence of sound polices, the gradual reduction of concessional lending in future years might be replaced by an increase flow of private resources, thereby favoring a smooth process of debt reduction without negative effects on growth.

The papers correctly point out that the scenarios do not take into account possible debt overhang effects, given the difficulty of modeling them into the scenarios themselves and the scarce literature supporting their existence in the case of HIPCs. Moreover, the effects of adverse shocks and cyclical downturns are not taken into account as well, together with those of favorable shocks and cyclical upturns. The consequences of such undesirable events are to be considered and the necessary corrective actions envisaged, in consideration of those cases where the soundness of policies and the seriousness of the adjustment effort are not rewarded by success due to the negative influence of adverse exogenous factors.

In conclusion, it is useful to stress that taking into account the potential fragility of the scenarios depicted is still appropriate and perhaps even necessary to keep this issue under review. But it is also very clear to me that this must be done on a case-by-case basis, in a framework where prospects are judged in relation to domestic efforts and the external environment. It is also clear that coping with the cases of demonstrated debt unsustainability must strengthen the incentive towards responsible, growth-oriented behavior. It is also clear that strategies should include efforts from all parties concerned. Finally, we consider that group beyond such an approach and lean towards new systemic incentive is unwarranted under present circumstances and with accumulated knowledge.

Ms. Lissakers made the following statement:

Many speakers have made a point that, without sound economic policies in the countries concerned, we can look forward to a scenario of continued restructuring and debt refinancing. I think that no one will challenge that point. The question is, what do we do with the cases where, even with good policy management, we can look forward for 10-15 years of continued refinancing and, in effect, if we are honest, debt restructuring? Is that really the best policy choice for us, for the multilateral development banks and for the Fund?

I think that is really the issue, because I think the analysis makes very clear that, while we can argue about how many countries should be included on the list, that is precisely the scenario we are laying out for a significant number of countries that are members of this institution, and of the World Bank across the street, and others. Is that the optimal policy scenario? Is there a way to deliver a quicker and more certain payoff for good policies if we pursue a different strategy with regard to the management of those countries' external debts, including their external debts to the multilateral institutions?

The Paris Club has said very clearly, yes, we think that it optimizes the returns on our development assistance if we accept debt reduction, very deep debt reduction in some cases. That is a better way to encourage sound policies and to deliver the payoff in terms of higher standards of living as opposed to simply continuing to finance the debt. It is not simply just a choice that is driven by the limits on official development assistance; it is a conclusion that has been drawn from the analysis of what the financial flows are and what the scenarios are that these countries face.

I do not think that the policy choices are very different for us, for the multilateral institutions, in some limited cases. I think the staff papers have made very great advances in our understanding of the individual cases and the enormous variations in the problem, which I think is very helpful. But the basic questions we face remain very much the same.

I would hope that we can come out of this discussion agreeing at least that, for a number of the poorest countries, even under our base assumptions, there are such serious problems it is difficult to imagine how they will achieve sustained economic development and full repayment of external liabilities without extraordinary measures.

Second, advancing reforms and achieving debt sustainability within a reasonable time frame should be a central objective in our support for development and growth in these economies. Third, I hope that we can begin to frame a set of common principles that will guide the decisions we make in addressing the debt problems squarely and honestly for the countries that are most severely burdened.

On the question of debt overhang, I think that certain other speakers have very clearly described the damage a debt overhang does to economic results, the results of good economic policies. It is obviously difficult to measure the consequences of the debt overhang precisely, as precisely as we would like, on an ex ante basis.

But I think one can look at the results of countries that did get debt relief first from commercial banks, and countries that have gotten debt relief from the Paris Club. The results show that such relief does in fact have positive results, and that it reinforces the determination to pursue sound policies and, as I say, delivers an earlier return on good policies.

It is true that Africa has not had that pattern yet, but we are fairly early in the stage of deep debt reduction through the Paris Club exercise for African countries. As we know, the debt overhang for many African countries is really a multilateral debt overhang. We have not really found a solution to that particular problem yet.

The debt overhang affects fiscal management, and I think the staff paper quite rightly points to the significance of that problem; others have mentioned it, too. I hope that we can do more work on that. I think that is a significant factor. I think we have to understand the damage that the reliance on arrears, the so-called "exceptional financing," which is a nice euphemism for stiffing your creditors, does to a country's ability to attract investment and to access commercial capital markets. That is what we want, after all. We do not want these countries to be perpetual welfare case, but that is really what we are talking about here.

An investment in a domestic asset is not very attractive if you know that, for the next 10 or 15 years, foreign exchange is going to be in extremely short supply because of the burden of debt servicing. It means you have to somehow have an extraordinary high rate of return in order to take the risk of investing in a local currency-denominated asset. That is a real disincentive for investment, for domestic investors and for foreign investors. So, while it is difficult to measure the impact of a debt overhang, I think there is a psychological impact, a real economic impact, and we should not understate it.

The paper asks pretty clearly whether new money or debt reduction is the better approach. I think that if we cut through the morass of financial flows, it is pretty clear that we have chosen the latter; we have chosen to provide new funds obviously to support development programs, projects, sound policies through ESAF, but we have also been refinancing payments to ourselves.

If you look at the net transfers--I know many people object to that concept, but I think it is legitimate to look at that in this context--between 1989 and 1993, for some 70 of the highest, most severely indebted poorest countries, IDA had a positive net transfer of $8.3 billion. The Fund had a negative transfer, had more repayments and debt servicing of $1.6 billion, and the World Bank received $4.4 billion more in payments of amortization and interest than it loaned out. So, the net positive flow was relatively modest.

This is perfectly legitimate if you have a group of countries that are really exiting their debt burden. But in fact we know that this is not the case for most of these countries. In fact, they are getting in deeper and deeper and are not, many of them, economic success cases. It is very clear from the staff's analysis that many of these countries do not have the capacity to service outstanding debt without new financing.

But, in many of these cases, certainly the small group clearly identified by the staff, without very deep concessionality, we are really pushing an ever growing snowball of debt into the future, and this is what the Paris Club has decided to stop doing. And as we all realize, what we are doing with the concessional financing and rolling over is that we are in effect partly forgiving debt.

The problem is that this piecemeal debt reduction, this "hidden debt reduction," works too slowly and, in some cases, may not work at all. At best, it keeps a very large number of countries always on the edge of unsustainability and barely creditworthy. If commodity prices or world growth take adverse turns, or official development assistance flows are less than anticipated, any one of these factors, regardless of whether countries pursue strong policies domestically, could push some countries over the edge. Is that really the best we can do? We do not really think so.

With regard to the response, I think there are a number of principles that we would certainly endorse. One is that when a country cannot reach sustainability without debt reduction, the creditor community should be prepared to make that possible. With regard to the number of countries affected, I think we would tend to side with the conclusion drawn by a number of speakers that we need to look very carefully at countries that are on the possibly stressed list, as well as the cases that are pretty clear-cut to be in an unsustainable situation for the foreseeable future, because of the many things that could go wrong.

Secondly, we need to look at the debts of the poorest countries in a comprehensive fashion so that we look at the community of debt. There must be clearly-defined eligibility criteria based on general debt sustainability ratios and potential policy reform efforts. We do not see any conflict between debt reduction and conditionality. On the contrary, it should be possible to design a program where they are mutually sustainable, first of all because you can explicitly link debt reduction concessions to policy performance; and secondly because, as others have pointed out, most of these countries are going to continue to need balance of payments financing in any event, and much of that will also be conditional.

We certainly see, as we have said, a continuing role for ESAF lending. Perhaps it will be necessary to have some of this be more concessional than it already is, and we must solve the financing problem for ESAF. We really see a link between the two problems, whatever solution we decide on. I do not think one can separate the future of ESAF from the debt problem.

To make a two-track approach of reform and debt action work, there must be clarity at the outset about the extent of the debt relief and a suitable time period for it to be made effective. Just as we recognize that a debt overhang discourages both investment and policy adjustment, we should ensure that debt reduction not be structured in a way that would impede adjustment efforts. Recipient countries should know up-front what kind of relief they can expect if they pursue sound policies. The time period over which debt relief occurs must be short enough to make completion of the process a realistic target for political leadership.

The debt reduction should be back-loaded, perhaps through a technique that allows a debtor country to accumulate debt-reduction rights to a pre-set reduction eligibility menu as it moves through the reform process. We think that whatever the multilateral institutions decide to do should complement and be coordinated with Paris Club efforts. As we say, we believe one needs a comprehensive approach, particularly given the enormous variations from country to country.

I also think that the multilateral institutions as a group must uphold the highest standards of transparency and accountability in their own lending. I must say that we reject the argument of some speakers that debt reduction would weaken the multilateral institutions. If we conclude that that is the most effective way to encourage sound policies and deliver the returns, it is not contrary to good financial management that once recognizes bad loans and that one follows up with specific measures. It is not contrary.

While there are institutional differences between the Fund and the World Bank that we certainly recognize, for the broad community it is not inconsistent and it is not contrary to good management of these institutions if we set out on an explicit program of debt reduction. More open and direct accounting is a basic prerequisite for sound finances, and the multilateral development banks should be paragons of transparency.

Transparency should include a sensible valuation of outstanding debt obligations and new lending. It should also extend to assumptions underlying future replenishments. The markets already recognize risk in these portfolios, and incorporate it in the valuation of underlying liquid assets and callable capital.

Finally, let me just say that we do not see debt reduction, if that is what it comes to, as a substitute for official development assistance or as a way to deal with the problem of shrinking development assistance. It is true that the two may be coinciding, unfortunate. It is really a question of what is the soundest way to (a) manage our institutions, and (b) promote good, rewarding economic policies in the poorest, most heavily debt-burdened countries in these institutions.

Mr. Esdar remarked that a net reflow of resources to the Fund was desirable because these were monetary resources. Furthermore, thus far under the ESAF, there had been a positive net flow of resources from the Fund to the heavily indebted poor countries and only a small group of countries had started making repayments.

Ms. Lissakers observed that the Fund and the World Bank had been extending concessional resources to indebted countries to enable them to make repurchases and repayments of earlier purchases and loans from the two institutions.

After adjourning at 1:00 p.m., the meeting reconvened at 2:00 p.m.

Ms. Lissakers noted that, in the absence of a debt reduction initiative, the debt burdens of the heavily indebted poor countries would continue to be at unsustainable levels. While the Fund would need to be involved in a solution to the debt problem, the nature of Fund involvement was an open question. Her chair recognized that the Fund's role in a debt initiative would differ from that of the multilateral development banks.

The Chairman noted that involvement by the Fund should be consistent with the monetary character of the institution.

Mr. Autheman observed that the Paris Club of official bilateral creditors had made debt relief conditional on sound policy performance in the context of Fund-supported programs. If the multilateral institutions were to follow a similar approach to debt relief, they would in essence be no different from official bilateral creditors.

Ms. Lissakers remarked that she had laid out some general principles for a debt initiative, including that debt relief should be conditional on sound policy performance and that action by multilateral institutions should be coordinated with other creditors, especially official bilateral creditors.

The Chairman remarked that initiatives by multilateral institutions would need to preserve their preferred creditor status and be consistent with their respective charters.

Mr. Grilli observed that he found it difficult to accept the assumption that debt relief would be the most effective way of encouraging countries to adopt sound policies. Furthermore, debt reduction by the Paris Club was not premised on the assumption that it would enhance development policies that were supported by bilateral creditors.

Mr. Evans recalled that the international financial community had, in the past, supported debt relief initiatives, such as the Brady Plan, the Naples terms of the Paris Club, and the IDA Debt Reduction Facility.

Ms. Lissakers observed that, during the debt crisis of the 1980s, commercial creditors had accepted the debt relief initiative under the Brady plan in the hope that such an initiative would increase the value of their assets, which it had.

The Chairman noted that markets had placed a value on the claims of commercial creditors, which was not the case for the debt owed to multilateral institutions.

Mr. Esdar remarked that he agreed with the Chairman that the debt to commercial creditors was different from the debt owed to multilateral institutions. In the case of the Brady initiative, markets had discounted the value of creditors' claims, so it was possible to have a clear picture of the markets' expectations.

Mr. Kang made the following statement:

I wish to thank staff for the set of informative papers. I believe that they provide useful information and analyses required for a more practical consideration of the debt issue in the coming months. In setting out the analytical framework and in providing detailed country analyses of debt sustainability, they meet part of the request of the Interim and Development Committees. However, they are still short of presenting specific strategies that may be considered in resolving the unsustainable debt burdens of a limited number of heavily-indebted poor countries.

Since Ministers are expecting to decide on a debt relief proposal at the April meeting, we urge Fund and Bank staff to develop considered proposals for presentation to the Ministers during the meeting. We can emphasize two principles, i.e., on the eligibility criteria and on the nature of the relief approach, that can guide staff in working out the specific debt relief strategies.

First, on the eligibility for new multilateral financial assistance, we strongly support the principle of directing funds to those countries that can use them effectively. We maintain that it is important for the Fund and the Bank not to relax their criteria for providing financial assistance in order to encourage countries to use funds productively.

Second, on the approach, we believe that there is merit in developing a comprehensive framework which can facilitate coordinated response by all creditors while allowing sufficient flexibility to address specific needs and circumstances of individual countries, and protecting the integrity of international financial institutions. Close collaboration and cooperation among creditors would be crucial in designing effective country-specific strategies. In this process, again I want to stress on the need to limit support to countries that have demonstrated a good track record of policy adjustments and a firm commitment to further adjustment and reform.

We believe that the present strategies in handling the debt burden of heavily-indebted poor countries may no longer be adequate. As the staff analysis clearly illustrates, some form of debt stock reduction may be required for a few countries.

Mr. Berrizbeitia made the following statement:

I would first like to thank the staff for the very interesting set of papers on the debt burden of some of our poorest members. The papers establish a generally satisfactory framework for the analysis of debt sustainability. Since the debt crisis of 1982, most of the middle-income countries have improved their debt situation substantially, but there are many low-income countries that are still experiencing serious difficulties managing not the service of their annual debt, but also the stock of their external debt, which remains very high for the weak economies. In general, independently of the analysis itself, empirical evidence tends to suggest that very high levels of external debt operate as a constraint on investment and growth, and, consequently, there could be a beneficial effect through appropriate debt reduction, providing, also, that there are sound policy environments in the countries involved. Whether debt reduction itself leads to better policies is another matter that I am not prepared to address at this point in time.

Touching upon some of the issues raised for discussion, on threshold levels, although comparisons, as Mr. Shaalan said, are not necessarily appropriate between middle-income Latin American countries in the debt crisis of the 1980s and the situation we are considering today, there is no question that the 200 to 250 percent threshold could be considered somewhat lower than was the case for those middle-income countries in the 1980s. On the other hand, in light of the overall fragility of the economies of most of the heavily indebted poor countries, I find the criteria to be broadly appropriate and to establish an appropriate framework for additional work. At any rate, they do not necessarily constitute a clear-cut guideline, but they do provide a general framework for particular analysis, and eventually for adopting specific measures. At any rate, a case-by-case approach will be the only way to proceed in this framework, while noting that the eventual viability of the sustainability of the debt in the long term will depend to a great degree on the exceptional financing that may become available in the future. Like Mr. Shaalan, I wonder why the net present value of debt service as a proportion of GDP was not considered as an indicator. I thought this might be a useful indicator, especially in the case of countries in which the external sector represents a relatively small proportion of GDP.

Regarding the time dimension, the time frame suggested by the staff seems reasonable, assuming that the underlying assumptions are not overly optimistic, particularly as regards projected export growth. I note, however, that somewhat surprisingly the debt-service ratio does not seem to be extremely sensitive to substantial reductions in the projected export growth volume. The example provides a 50 percent reduction in export volume growth and, yet, the changes in the debt-service ratio did not appear to be, at first glance at least, substantially increased.

As regards economic policy performance, there is no doubt that the staff's assumption is optimistic. But as the staff clarifies, it is more in the nature of a condition for the analysis than a forecast. The issue, as Mr. Evans points out, is whether better economic policies may well be attainable only in the context of more debt relief. Here, we are dealing with a classical problem of which comes first, the chicken or the egg. The short answer is that, yes, more conditional debt relief could lead to better policies. However, the more difficult question is, how much of the debt should be relieved and how to share the burden of such relief.

Touching upon risk factors, we are asked which factors should have been given more emphasis. All the risk factors that are identified have a potentially significant impact on the analysis, and the answer will depend on specific country analysis. However, we have already noted that sensitivity to export shortfalls does not seem to be very high as indicated by Table 6. My own inclination would be to concentrate closely on the underlying resource gap as an indicator of external financing requirements, presumably in the form of investment flows, even in the absence of debt service in the current account. If it is perceived that such levels of external financing of an investment nature would be difficult to attain, even with sound economic policies, then there are extremely serious risks involved, all the more so as the staff indicates that supply responses to sounds policies are subject to wide margins of error.

Like Mr. Koissy, another risk factor, which in my opinion has not received as much weight as it merits, is that of the fiscal burden. The level of debt service as a proportion of fiscal revenues could even constitute a threshold criteria for debt sustainability itself. Since such a level of fiscal burdens can possibly condition the ability for a country to maintain a sound policy stance and can condition its ability to adapt to external shocks. As a rule, I would suggest that a factor of 30 to 33 percent of debt service as a percentage of government revenues should be considered a threshold for debt sustainability.

The broader issues raised by the debt sustainability analysis are implicit in issue number six. That is, of course, what action should be adopted and what principal should guide the Fund in such a course of action. From the perspective of my chair, the following principles apply. First, the focus must be on a case-by-case approach. Second, a country must have a record of sound policies or be prepared to adopt sound policies in the context of very strong conditionality. This was emphasized by other speakers and particularly by Mr. Grilli who stated that weak policy performance is a basic cause of debt unsustainability, if I understood him correctly, and not necessarily the other way around.

Third, any proposed solution to unsustainable debt situations must not shift the burden unduly from bilateral to multilateral financial resources, and particularly to other users of multilateral resources. In this context, official bilateral debt represents 64 percent of the net present value of the overall debt burden of heavily indebted poor countries, whereas multilateral debt represents 19 percent of which the Fund only represents approximately 4 percent. Any burden sharing would need to take these elements into account on an equitable basis. The largest share of the burden must be borne in proportion to participation in the program. Furthermore, following Mr. Koissy's statement, bilateral loan commitments may have often be politically motivated and of dubious quality, perhaps granted without due regard to the economic risks involved, since we often speak of moral hazard in this Board when we discuss certain issues, I wonder if the morality of some or of much bilateral financing to the heavily indebted poor countries is not an issue that should also be taken into account in dealing with the burden sharing problem. I realize that this is a difficult proposition, but, we talk about moral hazard very often. I believe there are some moral hazard involved in shifting of bilateral responsibility toward a multilateral sphere, and that is what I am calling attention to.

Fourth, I agree with Mr. Evans that any action by the Fund must preserve its fiscal integrity and rely on the Bretton Woods own resources. I would add, as also other speakers have added, the monetary and financial character of our institution must be preserved, as it is included in the charter. Since the staff's analysis indicates an increasing multilateral share of financing for heavily indebted poor countries in the future, and as this results from the unfortunate decline in bilateral financing, that is, official development assistance (ODA), in particular, and since any decision involving multilateral debt relief implies a reduction of resources available for other uses, the issue of the Fund's and presumably the Bank's resources are all the more important. Therefore, the quality issue that we are discussing also acquires a high degree of relevance in the near future. So I think we must be consistent in these subjects. If we are saying that we are going to have to put more multilateral resources to solve some of these problems, then we have to be prepared to provide the Fund with the resources it needs or it will need to deal with these problems in the future. The stronger the resource position of the Fund the better placed it would be to provide assistance to heavily indebted poor countries.

Also, as indicated by Mr. Autheman, I think it is necessary to accelerate progress on agreeing on a permanent ESAF and make it as strong as possible. This is the fundamental mechanism through which sustained cooperation for heavily indebted poor countries can be maintained by the Fund. In general, I would agree with Mr. Autheman that a progressive improvement of the diverse mechanisms that currently exist to deal with debt problems is probably the best approach with an appropriate concentration of such efforts on a case-by-case basis on particularly indebted poor countries. What further role can or should be played by the Fund remains an open question as has been stated.

Although Mr. Clark raised some important issues toward the end of his comments, Mr. Esdar and others have made the point that the Fund is not directly part of the debt sustainability problem. This does not imply, however, that without compromising its principles in any way, the Fund could become part of the solution. The Fund should, perhaps, concentrate on those specific heavily indebted poor countries whose debt to the Fund is relatively more important and which are perceived as having unsustainable debt burdens, and it should continue to support sound policies in member countries that will help elicit a positive response from other creditors. I therefore agree with those prior speakers that consider that debt forgiveness is not an option that is compatible with the nature of this institution. If this were the case, I wonder how we are to reconcile proposals for Fund debt reductions with our rights accumulation program, or, for example, with our position with respect to Sudan, whom we are requesting to improve its policy stance? I find that there is some sort of a consistency problem there, as well. I can understand and share Ms. Lissakers's view, also expressed by Mr. Clark and Mr. Evans, that permanently rolling over debt is not a viable long-term solution. The issue, however, is that the Fund does not lie at the root of the debt overhang problem, and it is not clear that, in view of its very low participation, and the debt structure of practically all heavily indebted poor countries, whether such an important change in the Fund's position would help and it could harm the Fund in an irreparable manner.

To conclude, and taking up one of your latter comments, you said that multilateral institutions are special; as George Orwell, wrote, some animals may be more special than others.

Mr. Saito made the following statement:

I welcome this opportunity to discuss issues related to the debt problems of the poorest countries. Like other speakers, I would like to commend the staff of the Fund and the Bank for the high-quality papers prepared for this discussion.

Let me start by stressing the importance of one of the main outcomes of the empirical paper, namely, that, based on the strong assumptions regarding the international economic environment and the pursuit of sound macroeconomic policies, only 13 out of the 41 countries included in the analysis, can be considered sustainable using a five-year horizon. An additional 12 countries were classified as "possibly stressed," meaning that sustainability is likely in ten years. More importantly, eight of the 11 remaining countries were developed were determined to be unsustainable even after ten years of sustained strong macroeconomic policies, structural reform, and debt relief. This is extremely important as it shows clearly the magnitude of the debt burden of these countries. In this connection, I share Mr. Evans's view in relation to the potential bias of the analysis and the need to use caution rather than optimistic assumptions about the future. Therefore, I agree with his suggestion that, in the search for practical options, we should treat the unsustainable and "possibly stressed" countries in the same category as countries whose debt situation requires additional debt relief. Moreover, for many countries in this category, it seems clear that their debt problems remain unsolved, even after receiving substantial bilateral debt relief. For the latter group of countries, it is vital that all options remain open, including additional debt relief from multilaterals, provided that they meet the two conditions suggested by Mr. Evans.

At this stage, I will limit my remarks to some preliminary conclusions.

First, the debt problems of the heavily indebted poor countries may be larger than reported owing to the optimistic assumptions used by the staff in its analysis. It is discouraging to see that there is no way out for some countries, even after they pursue sound macroeconomic policies and continuous structural reforms and where, granted, debt relief under existing mechanisms. The result obtained when using five- to ten-year horizons for assessing sustainability provides a strong argument to implement appropriate policy reform and debt relief at an early stage.

Second, regarding the classification of countries as "possibly stressed" or unsustainable, as noted before, I do not consider this classification practical. A country that is categorized as "possibly stressed" can be rapidly assessed as unsustainable, if economic conditions change. This can happen despite an appropriate policy framework. There is always a downside risk in the economy of these countries that is not attributable to the management of the economic policy.

Third, as noted by several Directors, it seems that, in some cases, currently existing mechanisms are not sufficient to address the debt problem of the most heavily indebted poor countries. In this connection, I join other Directors in supporting ways for further strengthening Fund support to those countries on a case-by-case basis. Definitive solutions should be directed at achieving sustainability for all those countries, if no other solution is available, permanent debt relief would be desirable in areas where it does not exist currently. Further efforts should be made on the part of the international financial community to explore all possibilities in dealing more effectively with these issues. Additional multilateral debt relief could be an important step toward achieving the goal of "exiting" from the debt overhang situation. This is an equitable way of addressing the problems of heavily indebted poor countries without overburdening any particular donor country. We must keep in mind that the countries that will benefit from additional debt relief from multilaterals should be those that have a good track record in implementing adjustment policies and structural reform

Mr. Han made the following statement:

I would like to thank the staff for the set of papers for today's Board discussion. The study is helpful in providing us with a clearer picture of the prospects for debt sustainability in the heavily indebted poor countries. While further studies are to be expected from the joint efforts of the Fund and Bank staff, the current documents lend themselves well to our deliberation on future debt relief strategy.

Despite the enormous efforts made by the international community in the past decade, a group of low-income developing countries are still facing serious difficulties in managing and servicing their external debt. While the debt reduction under the Naples Terms of the Paris Club has provided some countries with badly needed relief, the accumulated high external debt stock has become one of the main obstacles for many low-income countries on their path to economic growth and social development. This will not only be a problem for the debtor countries in the next five to ten years, but also a challenge for the world economy that requires fundamental adjustment and closer international cooperation.

We believe fresh initiatives are urgently needed in order to reduce the debt burden of the heavily indebted poor countries. For some of these countries, debt reduction is almost a prerequisite for starting any effective structural adjustment program. In this respect, practical programs that incorporate balanced measures of macroeconomic adjustment and debt relief will lead to an active role for the Fund. While we are looking forward to the subsequent staff paper on the subject, in my opinion, the current papers have already provided with us some ground for further reflection on our future policy. I would like to make the following comments on the issues for discussion.

As regards the threshold levels prescribed by the staff for judging debt sustainability, while the country specifics are viable elements for an objective judgement, the indicators employed could provide a basic and preliminary measurement for cross-country comparison and individual country debt situation analysis. We believe a measure of the indebtedness of an economy, the ratio of debt to GDP, would provide us with meaningful guidance for a clearer assessment of the debt situation. In this connection, we believe a time period of five years at most is a viable indicator for judging debt sustainability. If we do not expect a country's debt position will improve in a five year period, we should regard the situation as unsustainable. Therefore, a new program ought to be implemented to begin an adjustment process. If we are too optimistic in making our judgement about future needs, we may not be ready to take action necessary to support the requested policy adjustments of debtor countries.

Among the number of identifiable factors that could influence our assessment of debt sustainability, we would like to draw the Board's attention to the prosect of steady economic growth, external current account viability, and the foreign exchange reserves position of the countries concerned. I would like to concur with the staff in emphasizing those country- specific circumstances that are sure to have important bearing on this question.

I am under the impression that the staff categorization underestimates the risk and difficulties confronted by many debtor countries. In other words, there seem to be more countries than are classified by the staff as having unsustainable debt-serving burdens. We tend to support the inclusion of the staff-categorized "possibly stressed" countries as a subtitle under unsustainable.

As for the source of financing on the part of multilateral institutions for the future debt relief programs, I fully share the view expressed by Mr. Evans in his statement that action by the Fund and the World Bank must rely on Bretton Woods' resources. As we have said on previous occasions, if the Fund could make its contribution with its own resources in supporting its members' economic adjustment programs, we could do more to convince the world that the Fund, as an intergovernmental institution, is able to fulfill its anticipated role in a changing world.

Mr. Kafka made the following statement:

I have very little to add to what other Directors have said. I am grateful to the staff for the quality of their report.

I agree that no debt relief is useful without strong adjustment policies. But also, no strong adjustment is likely, without debt relief for HIPCs.

Should debt relief include IFI resources? It would be difficult even with conditionality, but we could not wholly reject it. On risk indicators, the staff acknowledges a fair degree of arbitrariness in the thresholds used and we also are not fully convinced of the "best" choice of these thresholds for this group of countries, but know no better ones.

In terms of the selected time horizon we would suggest, like Mr. Evans, use of only the five-year benchmark for the reasons given by him.

The analysis shows that current mechanisms would not achieve sustainability for a number of countries and for these countries the task is to develop alternative strategies. We agree with Mr. Evans that improved economic policies may only be attainable with more debt relief than is assumed in the projections.

We look forward to the upcoming paper outlining the options to provide additional relief to these countries.

Mr. Kaeser made the following statement:

We thank the staff of the Fund and the Bank for their efforts to provide us with a broader analysis of the debt situation of the heavily indebted poor countries. Such an analysis, based on detailed and comprehensive country studies, is a useful complement to the stylized scenarios discussed previously. As these detailed studies only cover 23 out of the 41 concerned poor countries, we encourage the Bank and the Fund to complete the analysis of the remaining countries. Let us address the questions raised by staff.

Concerning the thresholds for debt and debt service, we agree that their determination is difficult and to some extent arbitrary. If a country cannot stabilize these ratios, there is a clear risk that the situation could be explosive and no sustainable equilibrium will be reached. There is, however, little consensus on the level that these ratios should reach in order to qualify the situation as sustainable. Such a level would depend on how these borrowed resources have been used and how the debt service is being financed. The reserve position of a country as well as its capacity to generate foreign exchange by other means than through exports (capital inflows, ODA) are also at play. However, though the empirical support for the particular threshold ranges used is weak, in the absence of any better alternative, we accept those proposed by the staff. An external debt problem may not necessarily be generated by a foreign exchange problem. If a government cannot gather enough revenue to purchase the needed foreign exchange, this would also lead to a debt problem. Therefore, we would suggest to add to the two selected criteria a third one, reflecting the fiscal burden of external debt such as the share in total public expenditure of debt service, for instance.

As to the time dimension of the debt sustainability, a five year period seems to be more reasonable than one of ten years. Which country can be expected to endure for ten years finger clamps? In the French literature there is a character called Salavin, who wished to become a saint. With this aim in view, he every morning gently crushed his fingers between the frame and the door of his bathroom, firmly believing that this daily suffering would make him a saint at the end of his life. Unfortunately, Mrs Salavin was not aware of the efforts of her husband to become a saint and one morning she slammed the door of the bathroom. That is what is called in "Fund speak" an external shock in the middle of an adjustment program. In other words, if a country is not able to improve its indicators within five years, there is little hope that it will manage to do so within ten. Requiring that countries immediately reach a sustainable debt level is clearly excessive.

Whether five, seven or ten years may represent the adequate time horizon for assessing debt sustainability seems a rather arbitrary choice and would probably need to be country specific. At this stage of the discussion, we think that the five- and ten-year periods selected by the staff in their study are useful benchmarks for illustrating the problem, but should not be used as rigid eligibility criteria for any new measure that may be implemented in the future.

The identification of the main risk factors that have a bearing on the assessment of sustainability is a useful approach. Such risk factors allow to sort out country specific problems and show the types of shocks those countries are particularly vulnerable to. We think that the staff has pointed out the most important risk factors. The diversity of the export base, aid reliance, the ratio of external debt servicing over fiscal revenue all underscore the vulnerability of a number of countries. These factors show once again the need for these countries to implement structural adjustment policies.

Turning to the categorization of countries, we think that this is useful for illustrative purposes, but should not constitute the base for any eligibility criteria. Moreover, looking at the sustainability ratios only at the end of these five- and ten-year periods may conceal difficulties at a specific point in time. Honduras, for instance, while classified as "sustainable", will face in the next four years debt service ratios well above 30 percent of its exports and 50 percent of its government revenues.

The staff asks if the scenarios are consistently too optimistic or too conservative. The recent study on investment and savings has shown that the projections for supply responses in Fund-supported programs tended often to be over optimistic. Moreover, policy reforms such as fiscal consolidation usually require considerably more time to be implemented than expected. We would therefore interpret the country scenarios presented today as the "best case" scenarios and not as forecasts.

The results of this study confirm the broad conclusions presented in previous staff papers discussed during the past year. There is no general multilateral debt problem. There is nevertheless a number of countries facing unsustainable debt burdens, since 20 out of the 41 countries included in the study turn out to have either an unsustainable or potentially stressed debt situation. As the composition of the external debt of highly indebted poor countries varies strongly, no single solution to their difficulties seems to exist. Any efforts to deal with the debt problem will thus require coordinate action by the range of creditors. Moreover, the absence of some creditors from any negotiating forum (non-Paris Club creditors) is worrisome. Efforts should be made to formally integrate them in the debt negotiating process. A first step could thus be the establishment of an institutional framework covering all types of debt, allowing an improved coordination in the efforts of alleviating debt problems and helping poor countries use to the fullest extent possible the existing mechanisms. A next step may be the examination of new instruments. As the review of the experience of debt reduction summarized in the analytical paper demonstrates, however, debt relief in the absence of a credible track record of sound economic management has little impact on private investment or on sustained improvements in country performance. No debt alleviating initiatives should therefore be envisaged without sound macroeconomic policies and economic reforms.

Finally, I would like to stress that the problem of the heavily indebted poor countries should be addressed with common sense and realism. I listened carefully to Ms. Lissakers's statement and I think that my authorities will be interested to know the message that she wished to pass to us. I noted in particular that in her view, there was no contradiction between debt reduction and conditionality. As I said, my authorities also contend that debt alleviation has little impact in the absence of sound economic management.

Further, in the spirit of realism, one cannot help but ask how many of the HIPCs would be viable under normal circumstances, i.e. if they would not have to bear a heavy burden of debt. A majority of HIPCs are located south of the Sahara. Many of them have a GNP in the range of the one of a medium-sized Swiss canton. Their economic viability will remain elusive as long as they are not ready to engage in a serious process of economic integration similar to those taking place in the rest of the world.

Mr. Kiekens made the following statement:

The thresholds proposed by the staff to signal whether a country's debt is sustainable, seem reasonable, given that their main purpose is to flag situations that may require closer examination. The staff's classification of the countries themselves is the result of an in-depth analysis and informed judgment, and I will not question it. I doubt that further refinements would yield very different results. Indeed, the results presented today do not differ much from those obtained some months ago by taking a so-called stylized approach to the problem.

The indicators proposed by the staff are sufficiently broad. I am, however, not convinced that, because the debt problems of many countries are related not only to external debts but also to domestic fiscal problems, the ratio of debt to total government revenues should be included in the set of sustainability indicators. In many of these countries, government revenues are very low in GDP terms and often fluctuate widely depending on the ability and willingness of the government to collect fiscal revenues.

One of the problems with today's analysis is its dynamic character, which makes it difficult to fully reflect the risks confronting these countries. I fully recognize that adjustment takes time to yield results, but once it takes hold the adjusting countries may even overshoot their targets. Taking account of all these factors, I agree with the staff's proposed time frames for expecting a country's debt position to improve.

Agreement on the assessment is a good starting point for discussing solutions. The staff paper raise several points that should help lay the groundwork for our future discussions about solutions. In my view, these solutions should include the following elements.

Conditionality must be part of any solution, as all speakers this morning stressed. The heavily indebted countries have a continuing need to adjust. The disappearance of a debt overhang in a country that does not adjust can only be temporary, and the effects of external support, in whatever form, will be very short-lived. Sustained growth depends mainly on success in mobilizing domestic savings in addition to external savings. There is little use in providing generous conditions to heavily indebted countries until there is reasonable assurance that the lightening of the debt burden will promote the mobilization of domestic savings. To proceed otherwise is to put at risk the monetary character of the Fund's assistance.

Debt overhangs are sometimes so severe that they need to be addressed specifically. But as just noted, a one-time rescue operation without sustained adjustment will not lead to viability in the medium term. A more dynamic approach, involving a continuous policy dialogue, is required. In most cases, these countries' heavy indebtedness results from years of failure to adjust. It is not reasonable to suppose that a debt exit strategy, that only removes the consequences of a failure to adjust, is in itself likely to promote the adjustment in the future that was lacking in the past.

There may be a few countries which have no reasonable hope of graduating from their debt. The debt composition of these countries varies, requiring a response tailored to each case, and better coordination than at present among the international financial institutions. The most critical and sensitive question is whether, in these cases, debt relief should be granted by multilateral institutions. I believe that so far, such a measure has not been proven or accepted as being unavoidable. However, if we should come to such a finding, then the debt relief should be granted only in a gradual fashion, as a post-factum reward for good policy implementation, and not ex ante, nor up front, as is the case with the Paris

Club debt relief operations. It would require a general framework involving all multilateral institutions and assurances of future bilateral ODA support. Under such a strategy, the so-called revalidation period is of critical importance, during which the most support is needed and strong surveillance is required. During this period, the country is very weak and vulnerable to external shocks. Perhaps we should therefore consider ways of promoting the continuity of the adjustment by protecting the country against possible external shocks, such as drops in export prices and negative world growth. However, declines in ODA should not be considered as an exogenous shock, since an integral part of the debt relief strategies should also be future assurances of ODA. Debt relief by multilateral financial institutions is no substitute for bilateral ODA. The goal of increased protection against external shock during the revalidation period may be pursued via more elaborate contingency clauses. It goes without saying that under such a scheme, the specificity of the various multilateral financial institutions, particularly the monetary character of the Fund, must be safeguarded. I therefore expect that the Fund will only be associated with debt relief operations through its ESAF programs with their conditionality. For the same reason, I do not believe the Fund should create a new instrument to cope with the debt of the heavily indebted poor countries. More generally, and as a first and probably sufficient action, the existing instruments should be reviewed to see how their scope and results can be improved, much along the lines suggested by Mr. Autheman this morning.

Mr. Vernikov made the following statement:

I would like to join those Directors who commended the work carried out by the staff. Indeed, the two papers make a substantial contribution to the ongoing discussion of the debt situation of low-income countries. It is especially important that this time the staff has undertaken a sensitivity analysis for the countries involved, thus allowing us to evaluate the situation more adequately. Another welcome phenomenon is that the staffs of both Bretton Woods institutions contributed to the study, thus reflecting common views and approaches.

I think that the criteria proposed by the staff with regard to individual country's debt sustainability are satisfactory and quite workable, for analytical purposes. As for the time dimension, the dual time horizon--five years and ten years--seems to be appropriate too. The specific categorization of countries' debt situations (as sustainable, stressed or unsustainable) can serve the purposes of the analysis. I assume that this categorization has required a certain degree of boldness on the part of the staff, because identifying the debt situation of a significant number of poor countries as "sustainable " is likely to trigger criticism from those analysts who tend to overgeneralize the problem.

Answering one of the questions for discussion, I would say that, because the scenarios of each country's debt profile for the next several years are based on uniform assumptions, it is hard to consider the outlook for this or another country as either too optimistic or too conservative. Rather, general assumptions themselves may be tested for optimism or pessimism. On balance, the study is based on realistic assumptions. Still, the responsiveness of private investment inflows to sound policies is hard to quantify, especially for countries with a poor track record. Also, it is true that shocks are far more often negative than positive.

There is another assumption that I would like to mention, namely the treatment of the debt to non-Paris Club official creditors. For some reason, the staff paper on debt-sustainability analysis implies, for example, that the very fact of a preponderance of Russian claims in the total debt of certain countries enables us to assume that these claims receive somewhat more favorable treatment (page 7). This implied approach has affected the presentation in at least one country case. On page 68, the breakdown of a country's external debt is presented as follows: "largest part Russia; remainder: multilateral 7 percent); Paris Club 39 percent; other bilateral 16 percent; commercial 38 percent." I do not understand the economic criterion (if any) underlying the split of a country's total external debt into two broad categories--Russian claims and "remainder", where the larger component is not even explicitly quantified. It would have been more consistent to present the breakdown in an integrated form, with a clear quantification of each component.

In a different context, the staff paper on analytical aspects notes that "in some instances, notably the claims of Russia, the valuation of non-Paris Club creditor claims has been the subject of dispute between creditors and debtors, reflecting among other things, differences on the appropriate exchange rate to use in valuation" (page 1). Just for reference, my authorities have sufficient reasons to defend their view on the substance of the disputes over the valuation problem.

The principle of comparability of treatment of different creditor groups has served the international community well and must be maintained. In this connection, it might be prudent for the staff to avoid the temptation of minimizing the scale of any aspect of the debt problem of some poor countries, even if it resulted in a regrettable re-classification of their debt profile (e.g., from "sustainable" to "possibly stressed").

Finally, I would agree with the staff that we should pay more attention to the fiscal dimension of debt sustainability, because the external payments situation and the government budget should be considered alongside each other.

I once again thank the staff for their excellent work, and look forward to receiving a further paper setting out any specific additional actions that might be needed to assist poor countries in their debt situations.

Mr. Himani made the following statement:

I join other Directors in thanking the staff for a useful analysis of debt sustainability of the heavily indebted poor countries. I share much of the staff's conclusions regarding the debt burden of these countries. Of course, these conclusions are predicated on a number of assumptions and are subject to a high degree of uncertainty. This uncertainty will certainly increase as we go further into the future. At the same time, establishing a track record of sound economic management and gaining investors' confidence is itself a lengthy process. Thus, on balance, the staff's time horizon for reaching the thresholds as well as their categorization of countries appears broadly satisfactory.

While a majority of these countries are expected to grow out of their debt problems in ten years or less, it is obvious that reaching this objective will not be easy and will require forceful efforts. Moreover, for a few countries, the staff's analysis indicate that their debt burden is unsustainable, even following stock-of-debt reductions on Naples terms. In such cases, several other Directors have pointed out, solutions can be explored based on existing mechanisms. It is also amply clear that prudent policies and a stable environment are the cornerstone of good economic performance and strong investors' confidence. Under such circumstances, the Fund's main contribution should remain in the areas of providing macroeconomic advice and technical assistance.

Having said this, concessional lending under the ESAF should also continue to play an important role in supporting the adjustment effort. In providing such financing, however, we should keep in mind the monetary, catalytic and revolving nature of Fund resources. Safeguarding the financial integrity of the Fund is an important element for ensuring the institution's ability to continue to provide assistance to its members.

Mr. Ahmed said that he strongly supported the views expressed by Mr. Evans, Mr. Koissy, Mr. Shaalan, and Mrs. Guti. Executive Directors had expressed considerable interest in the use of fiscal indicators in the debt-sustainabilities analysis while the staff had included the fiscal dimension in its risk indicators, he wondered whether or not the fiscal dimension could be incorporated in some sort of explicit or systematic way along with the more traditional external indicators. Furthermore, he wondered whether the results would have been substantially different, if the staff had used the fiscal indicators in its analysis.

The Deputy Director of the Research Department noted that empirical studies on the debt of the middle-income countries in the mid-1980s had found limited evidence of direct effects of debt overhang. As regards the heavily indebted poor countries, the few existing econometric studies suggested negative effects of debt on private investment; however, it was difficult to separate the debt overhang effect, that is, the impact of future debt payments on current investment, from the "crowding-out" effect, that is, the effect of current debt payments on current investment. The studies suggested that most of the effects were crowding out effects. However, owing to the high degree of collinearity between the debt servicing and debt stock variables in the investment equations, it was difficult to draw firm conclusions from the empirical evidence. As the main effect of debt appeared to be a crowding out of investment, it could be expected that debt reduction on increased concessional financing would result in higher investment. Conditionality would certainly play a role in determining whether the resources generated from debt reduction would result in higher investment rather than higher consumption.

There was no strong empirical evidence to suggest that there had been indirect effects of debt overhang for the middle-income countries, the Deputy Director continued. While debt reduction under the Brady Plan played a role, the data indicated that macroeconomic stabilization prior to debt reduction was crucial to the success of the Brady Plan; in addition, by reducing uncertainty, the Brady Plan had had a positive effect on growth.

The Director of the Policy Development and Review Department observed that the staff paper had shown that there was mixed evidence on whether debt overhang discouraged investment. There was one important difference between the debt relief provided by the commercial banks to middle income countries in the 1980s and the debt relief currently being sought from official bilateral and multilateral creditors: in the former, the commercial banks did not expect that they would continue to lend afresh to those countries during the debt relief process, while, in the latter case, official creditors would continue to support adjustment programs of the heavily indebted poor countries. The staff would continue to assess the debt burdens of individual countries and would keep the Board informed on developments in that area.

In making the projections, the staff had tried to assess the impact of adjustment programs on countries' debt burdens, the Director continued. The possible impact of external shocks was not incorporated in the projections. Furthermore, the staff did not consider that the projections for export and import growth were optimistic; excluding CFA franc zone countries, the projected export growth in the heavily indebted countries was lower than it had been in the previous five years. Similarly, on the import side, the import elasticity of demand was expected to be above 1 for the next five years, contrary to the experience of the previous five years.

The staff was in contact with the Russian authorities and debtor countries and was trying to assess the magnitude of the debt owed to the Russian Federation, the Director of the Policy Development and Review Department noted. The dispute between the Russian authorities and the authorities of the debtor countries about the exact value of the claims owed to the Russian Federation was complicating assessment of the debt burden.

Ms. Lissakers observed that, during the 1980s debt crisis, commercial banks had not withdrawn from the middle-income indebted countries. They had been active underwriters of bonds and had made equity investments in many of those countries. Later, they had also resumed their lending operations..

The First Deputy Managing Director remarked that commercial banks had initially resisted involvement in the debt initiative in the 1980s, but had gone along with the approach taken by the international financial community.

Ms. Lissakers remarked that the commercial banks had accepted the Brady Plan because the markets had downgraded the value of the banks' loans, and banks had realized that the only way for them to raise the value of their claims was through a debt relief initiative.

Mr. Evans observed that the staff scenarios were optimistic and did not take into account the adverse effects of debt overhang on private and public sector investment. Unless the international financial institutions played a role in eliminating the debt overhang, the poor countries would be faced with the same situation that the middle-income indebted counties had been faced with in the 1980s, namely, that future flow of private and official capital would be in jeopardy.

The Deputy Director of the Policy Development and Review Department stated that the staff had used debt/exports and debt service/exports ratios to evaluate debt sustainability because they were better indicators of countries' debt problems than the debt/GDP ratio or fiscal indicators. The real issue was the availability of foreign exchange, and the ability of most of the countries to convert GDP into foreign exchange was limited. The staff had used fiscal indicators the previous year in its study on official financing for developing countries and had found a high correlation between the debt service/exports and the debt service/government revenues indicators. Also, the staff was more confident about the trends for export growth than it was about future developments regarding the public finances of the countries concerned. The staff had therefore included the fiscal situation as a risk factor in its projections.

Ms. Lissakers observed that the debt problem was not simply a balance of payments problem, but also had a fiscal dimension. A debt overhang had adverse effects on investment and resulted in the allocation of scarce public resources to debt servicing.

Mr. Berrizbeita asked why the debt service/export ratio did not increase in proportion to the 50 percent reduction in the rate of growth exports in the staff's sensitivity analysis..

The Director of the Policy Development and Review Department noted that in some of the cases the debt service/export ratio increased by 25 percent, while in other cases the increase was less than expected. The staff would be examining the individual cases further.

The Chairman made the following concluding remarks:

> I will summarize briefly Directors' views and comments on the analysis in the two staff papers, before concluding with some observations on what is implied for the task now ahead of us, which is to develop specific proposals for action.
>
> On the scope and nature of the debt problems of the heavily indebted poor countries, a number of Directors drew attention to the difficulties involved in coming to a firm judgment in this area. They noted that, at a theoretical level, there were several possible reasons to expect high levels of debt to adversely affect economic performance. How important these effects were, however, is difficult to determine and depends on country-specific circumstances. The empirical evidence is inconclusive. Speakers generally emphasized that sound economic management and persistence in implementing reforms were likely to be over-riding factors in determining both long-term economic performance and the ability of countries to service their debts. But it was also generally acknowledged that persistently high levels of debt may intensify the risks that countries face in an uncertain external environment and that may undermine confidence, potentially crowding out private investment and hindering economic growth. Moreover, there was broad recognition in the international community, as embodied in several debt reduction initiatives, including Paris Club procedures, that the opportunity for countries to "exit" from a continuous cycle of reschedulings can reap benefits for debtors and creditors alike.
>
> Directors agreed that the methodology proposed by the staff for assessing debt sustainability was broadly appropriate and helped to clarify some of the key issues. While noting that the use of the indicators and quantitative thresholds inevitably involved important judgmental elements, most Directors believed that these were a useful tool when looked at in conjunction with the range of other factors set out in the staff paper. They broadly agreed with the proposed criteria for judging sustainability and with the list of countries classified as having

unsustainable debt burdens. The situation of those countries classified as "possibly stressed" was more difficult to determine and more sensitive to changes in assumptions. Some Directors thought that the number of countries facing unsustainable debt burdens could be larger than that suggested by the staff, and it was agreed that the situation of the "possibly stressed" countries needed to be kept under close review. Some Directors believed that a more rapid improvement in the debt indicators should be required in order to classify a country's debt situation as sustainable. Others observed, however, that countries that had pursued sound policies had been able to combine strong economic performance with high levels of debt service over periods substantially longer than the five-year horizon used in the analysis.

Several Directors observed that the staff had approached the debt sustainability analysis from a balance of payments perspective. In future work, they encouraged the staff to consider further the fiscal implications, especially the effects of external debt-service payments on government revenue and the structure of public expenditures. This view, however, was not shared by all speakers.

Also on methodology, a number of Directors commented that the scenarios on which the analysis and conclusions were based depended not only on strong and consistent policy implementation, but also on strong private sector responses. In most cases, the projections assume increased investment, buoyant export growth, and rising capital inflows from abroad. Again, however, opinions differed as to the appropriateness of these assumptions. Some suggested that they were excessively optimistic, while others noted that they were not out of line with the experience in those countries that had in fact adhered to adjustment and reform policies.

Notwithstanding these uncertainties, many Directors supported the staff's assessment that, for the majority of the heavily indebted poor countries, sound policies coupled with new concessional financing and debt relief under current mechanisms would be sufficient to achieve debt sustainability in the medium term. It was pointed out that efforts were needed, and some were already under way, to enhance current mechanisms, including the establishment of a self-sustained ESAF, an increase in the provision of official development assistance resources to multilateral institutions and to the poorest countries, more bilateral support under the Paris Club, and greater efforts on the part of non-Paris Club official bilateral creditors.

At the same time, however, it was recognized that for a number of highly indebted poor countries the burden of debt was likely to remain above sustainable levels over the medium term, even with strong policies and full use of existing debt relief mechanisms. For these countries it was also recognized that their reform and development efforts may be put at risk by continued high debt and debt-service burdens. There is a broad consensus that this is not a satisfactory situation, and that the Fund, together with the international community, needs to find ways to effectively assure countries with unsustainable debt situations that also help themselves that their efforts will not be undermined by an excessive burden of debt. In that context, some Directors considered that support from the Fund and the World Bank should rely on the Bretton Woods institutions' own resources, while others stressed the need to find a cooperative strategy involving a broader group of creditors.

This discussion suggests that there are six "building blocks" on which there is broad agreement, and on which we can base our future work.

First, we should target overall debt sustainability as an objective, on a case-by-case basis, focusing on the totality of the country's debt, rather than on the debt due to any single creditor group.

Second, we should envisage action only when the debtor has shown, through a track record of reform and sound policies, the ability to put whatever exceptional external support is provided to good use to achieve a sustainable outcome.

Third, we must build, as much as possible, on existing mechanisms, including, in the case of the Fund, through a continuation of ESAF-type operations.

Fourth, for the problem cases, additional action should be coordinated among all creditors involved.

Fifth, any action on relieving the burden of debt owed to multilateral creditors should be consistent with the financial integrity of the institutions, the constraints of their charters, and their preferred creditor status, to ensure that the institutions can continue providing member countries with financing on appropriate terms without being hampered by a special effort for this group of countries.

Sixth, new external finance for these countries should be on appropriately concessional terms, in order to support their efforts to pursue reform and establish a track record of good policies.

During the next few weeks we will have several informal meetings to try to develop from these six "building blocks," in coordination with the World Bank and the multilateral regional development banks, specific proposals for action to address the debt problems of the heavily indebted poor countries.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/12 (1/16/96) and EBM/96/13 (1/20/96).

3. EXECUTIVE BOARD - INFORMAL RECESS

The proposed period for the Executive Board's informal recess as set forth in EBAP/96/5 (1/30/96) is approved.

Adopted February 16, 1996

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/96/7, Supplement 2 (2/15/96) is approved.

APPROVAL: February 11, 1997

REINHARD H. MUNZBERG
Secretary