April 21, 1997
Approval: 4/28/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/56

10:00 a.m., June 12, 1996

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman

Executive Directors

A.A. Al-Tuwaijri

M.-A. Autheman

L.E. Berrizbeitia

I.D. Clark

B.S. Dlamini

H. Evans

E.R. Grilli
J.E. Ismael
D. Kaeser

A. Kafka

W. Kiekens
Y.-M. T. Koissy

K. Lissakers

H. Mesaki
A. Mirakhor

C. Saito
S. Schoenberg
A.S. Shaalan

E. Srejber

E.L. Waterman
J. de Beaufort Wijnholds

Zhang Z.

Alternate Executive Directors

S.M. Al-Turki
O.A. Himani, Temporary
A. Fayolle
H. Paris, Temporary
V.J. Fernández
A. Galicia-Escotto, Temporary
R. Rainford, Temporary
C.K. Duenwald, Temporary
D.Z. Guti
J.A.K. Munthali, Temporary
J. Shields
J.W. Dagustun, Temporary
H.B. Disanayaka
R. Kannan, Temporary
N. Coumbis

W.C. Keller, Temporary
O. Issaev, Temporary
A. Calderón
H. Mori, Temporary
M. Nemli, Temporary
H.A. Barro Chambrier
K. Kpetigo, Temporary
B.S. Newman
D.G. Loevinger, Temporary
Y. Tahara, Temporary
M. Daïri
M.A. Hammoudi, Temporary
A.G. Zoccali
B. Esdar
Y.Y. Mohammed
G. Iradian, Temporary
B. Andersen
A.V. Vernikov, Temporary
J.-H. Kang
Y.G. Yakusha
G.A. Kyriacou, Temporary
Han M.

R.H. Munzberg, Associate Secretary
S. Bhatia, Assistant
M. Cuc, Assistant

Also Present

IBRD: J.W. Adams, A. Cisse, Africa Regional Office; F.H. Jensen, N. Kamel, Financial Policy Department. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director; C. Brachet, Deputy Director; G.E. Gondwe, Deputy Director; A.I. Abdi, P.A. Acquah, C.L.M. Chirwa, S.M. Darbar, J.E.K. de Vrijer, I.A.H. Diogo, A. Fedelino, M. Fouad, C.A. François, M. Katz, V. Kramarenko, M.W. Lewis, M.I. Matungulu, P.D. Peroz, A. Tahari, G. Taube. External Relations Department: S.J. Anjaria, Director; A.P. Kireyev, H.P. Puentes. Fiscal Affairs Department: M.Z. Yucelik. IMF Institute: M.R. Rached. Legal Department: W.E. Holder, Deputy General Counsel; H. Elizalde, S. Gong, H.V. Morais, D.E. Siegel. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; R.M. Brooks, B. Christensen, C. Daseking, S.Y.-L. Jen, A. C. Kouwenaar, K.H. Lee, S.M. Nsouli, D.C. Ross. Research Department: P. Wickham. Secretary's Department: W.S. Tseng, Deputy Secretary; J.M. Boughton, K.S. Friedman, J.J. Polak, G. Walton. Southeast Asia and Pacific Department: K. Saito, Director. Treasurer's Department: D. Williams, Treasurer; D. Gupta, Deputy Treasurer; Y. Atsumi, Z. Farhadian-Lorie, C.A. Hatch, D.M. Hicks, B.A. Hindawi, F.M. Meek, P.R. Menon, I. Otker, M.A. Wattleworth. Western Hemisphere Department: P.D. Brenner. Office of the Managing Director: S. Sugisaki, Special Advisor; J.A. Quick, Personal Assistant; D. Burton, H.L. Mendis. Advisors to Executive Directors: M. Alemán, R.F. Cippa, A. Cserés, S.S. Farid, T.K. Gaspard, K.M. Heinonen, A.R. Ismael, J. Jonáš, J.M. Jones, J. Justiniano, B. Konan, M.H. Mahdavian, Y. Margoninsky, G. Mucibabici, S. N'guiamba, S. O'Connor, J.-C. Obame, M. Petrie, K. Sundara, R. von Kleist. Assistants to Executive Directors: S. Arifin, T. Berrihun, R.D. Bessone Basto, J.G. Borpujari, M.A. Brettschneider, A.G. Cathcart, D. Daco, D. Giga, M. Giulimondi, R. Glennerster, C.M. Gonzalez, D.S. Hakura, R.J. Heinbuecher, Huang X., P. Jilek, E. Kouprianova, T.-M. Kudiwu, B.M. Lvin, J. Mafararikwa, I. Moon, G.P. Ramdas, S. Rouai, M.W. Ryan, G. Schlitzer, T. Sitorus, Song J., V. Trivedi, L.B.J. van Geest, A.-G. Yakub, E.L. Zamalloa, Zheng H.

1. MESSAGE OF CONDOLENCE

The Managing Director paid tribute to Edward M. Bernstein, former Director of Research, with the following statement:

Edward Bernstein, who died June 8 at the age of 91, was a central figure in the history of the International Monetary Fund. As deputy to Harry Dexter White at the U.S. Treasury in the early 1940s, he was instrumental in developing both the U.S. plan and the final compromise for the Fund's Articles of Agreement. At the Bretton Woods conference in 1944, he was both the chief technical advisor and the principal spokesman for the U.S. delegation. When the Fund opened its doors in 1946, he became the first Director of Research, a position that he held until he left the Fund in 1958. He was, in effect, the chief economist of the Fund, and he had an enormous beneficial impact on this institution for which we are all extremely grateful.

Throughout his long and productive life, Eddie Bernstein was keenly involved in and supportive of the work and role of the Fund. Just two months ago he attended our Seminar on the Future of the SDR, at which he was recognized for his pioneering work on the role of international reserve assets, work that helped make possible the creation of the SDR in 1969. But the idea of a composite reserve asset was just one of his many contributions to the Fund. The concepts of Stand-By Arrangements, conditionality, and surveillance all were honed on the anvil of his intellect. Perhaps, though, his most lasting contribution was that he attracted many of the brightest economists of his time to work at the Fund: Sydney Alexander, Marcus Fleming, Robert Mundell, Jacques Polak, Robert Triffin, and numerous others, thus demonstrating that the Fund can and must have an international staff of the highest quality.

From the beginning, Eddie believed that inflation would be as great a threat as deflation to economic stability after World War II. A hallmark of his writing on this issue, as in everything that he wrote, was that he saw the need for balance. The Fund had to have enough resources to help its member countries avoid deflation, but it also had to have the means to impose the conditionality that would help them avoid inflation.

One of Eddie Bernstein's guiding lights throughout his career was the value of a system of stable exchange rates to promote the growth of international trade and world income. Having witnessed the debacle of the deflation of the 1930s, he worked tirelessly in the years before Bretton Woods to devise an international monetary system that not only would prevent a relapse into competitive devaluations and autarky, but also would provide positive incentives for trade and growth.

Although he took early retirement from the Fund, Eddie never retired from studying and writing about the Fund and the international monetary system. In fact, he worked for almost forty more years after leaving the Fund, first as the head of his own consulting firm, and later as a guest scholar at the

Brookings Institution. In July 1984, exactly forty years after Bretton Woods, he reflected on the changes in the world economy during an anniversary luncheon with Executive Directors here at the Fund. On that occasion, he lamented the massive appreciation of the U.S. dollar that was still under way, and he noted that it was having disastrous effects on many developing countries as well as on the major industrial countries. But he also recognized that the solution to the problem was not to try to return to a system of par values for exchange rate—not a "new Bretton Woods." Rather, the solution was to have better and more stable macroeconomic policies, and to obtain better policies it was important for the Fund to exercise firm surveillance. He believed that the Fund had the means to promote stability, and that our role was even more important in today's—that was 1984, but it would also have been right in 1994, and will be in 2004—more volatile world than it had been in the 1950s and 1960s. This is, indeed, only an illustration of his permanent concern about this institution and the role of the Fund.

We have lost a great man. I have sent a message to his widow to tell her that he will stay in our memories.

2. ENHANCED STRUCTURAL ADJUSTMENT FACILITY—OPTIONS FOR CONTINUED FINANCING—FURTHER CONSIDERATION

The Executive Directors considered a staff paper on ESAF financing options (EBS/96/76, 5/15/96; and Cor. 1, 5/20/96). They also had before them a background paper on preliminary costing of the proposed framework for resolving the debt problems of the heavily indebted poor countries (SM/96/127, 6/4/96).

The Managing Director made the following statement:

Last month, the Interim Committee reiterated its support for a continuation of the ESAF, including establishment of a self-sustained ESAF, as the centerpiece of the Fund's strategy to help low-income countries, including in the context of the proposed initiative to assist the most heavily indebted poor countries (HIPCs). I was particularly heartened by the universal support expressed by Committee members for the important role played by the ESAF in assisting strong policy reforms in the poorest of our members. The Committee asked the Executive Board to conclude its discussions on financing modalities for the ESAF as soon as possible and to present proposals by the time of the Annual Meetings. It is urgent that we now make progress on agreeing on such proposals.

Let me list the considerations why I continue to believe that modified Option 1 or 1(a) would represent the first-best solution to the issues we face. This conclusion, I believe, has been strengthened by the incorporation of the possible costs to the Fund of the proposed HIPC Initiative.

First, the early withdrawal of resources in the Reserve Account for either principal or interest subsidies on ESAF-type operations during 2000–04, before they would have been allowed to build up to a critical mass, would impair the capacity for self-sustained ESAF operations and may lead to requests for a gold pledge from bilateral lenders to substitute in full or in part for reduced protection of their claims on the ESAF Trust. Since early use of the Special Disbursement Account (SDA) resources may also be needed to finance the Fund's contribution to the HIPC Initiative, the withdrawal from the Reserve Account for regular ESAF operations should be minimized.

Second, bilateral contributions for subsidies (including through the Special Contingent Account (SCA-2) refunds) are an essential feature of the ESAF. They are a tangible signal of members' strong support for the ESAF, and of the importance of its role in enhancing the efficiency of bilateral aid. This was also confirmed during the Interim Committee meeting by the support from many members for testing the feasibility of bilateral contributions. Let me note that bilateral contributions on the order of SDR 1 billion—over 18 years—as under Option 1 or 1(a), would appear to be a relatively small investment to ensure ESAF operations at a reasonable level on a fully self-sustained basis.

Third, members' budgetary constraints are a fact of life, and I have therefore proposed that about half of the subsidy financing be secured from the investment income from profits on a modest sale of the Fund's gold (up to 5 million ounces). The Fund's capital in the form of the corpus of the profits from such sales would be maintained at all times; generating investment income from these profits would avoid eating into the Fund's capital in other forms, such as by using up SDA resources or—potentially—use of the Fund's gold through activation of a gold pledge.

Fourth, the temporary use of the General Resources Account (GRA) for principal during 2000–04, pending the start of self-sustained operations thereafter, would provide a reasonable balance between preserving the monetary character of the Fund and assuring a sufficient level of loan resources to sustain an annual commitment level in line with the expected needs of our poorest members. In this context, I would note a number of drawbacks of extended use of GRA resources beyond 2004, as embodied in "sunsetting" options: not only would this preclude a self-sustained ESAF, as called for by the Interim Committee, it would also imply full consumption of the capital of SDA resources, as well as prolonged exposure of GRA resources, with a need for increased precautionary balances within the GRA. This last requirement would, of course, place a demand on members not unlike that represented by bilateral contributions. Let me add, however, that the choice between a self-sustained ESAF and "sunsetting" would not have to be made now.

Given these considerations, I believe that Option 1 or Option 1(a) would ensure in a balanced manner continuation of ESAF operations at a reasonable commitment level. The amount of gold sales I have proposed, 5 million ounces, would provide some margin to accommodate part of the costs of the Fund's participation in the HIPC Initiative, although it could also be considered to raise additional resources from other sources, including somewhat larger bilateral contributions, so as to minimize the impact of the Fund's participation in the HIPC Initiative on the capacity of the self-sustained ESAF.

Finally, as you know, I have written to a broad segment of Fund members to seek bilateral contributions for ESAF operations during 2000–04. Let me appeal to all member countries to indicate as soon as possible their potential commitments of bilateral support so that we can put forward realistic proposals to the Interim Committee.

The Director of the Policy Development and Review Department made the following statement:

This note explains the differences in the estimates of the total potential costs of action under the heavily indebted poor countries (HIPC) debt initiative presented in the technical note on preliminary costing of the proposed framework for the initiative (SM/96/127, 6/4/96) and the earlier estimates presented (a) in the paper on ESAF financing modalities (EBS/96/76, 5/15/96) and (b) in the question and answer brief on the HIPC debt initiative (SM/96/81, Sup. 1, 4/4/96).

The ESAF financing modalities paper (EBS/96/76, 5/15/96) included an estimate for the total potential costs of the HIPC debt initiative of US$7 billion, in 1996 net present value terms. This has since been revised to US$5.6 billion (as presented in the technical note (SM/96/127, 6/4/96). The estimate of US$7 billion included costs associated with Côte d'Ivoire based on projections that the net present value of Côte d'Ivoire's total external debt-exports ratio would be above 200 percent at its hypothetical completion date.

Further analysis by the staffs of the Bank and the Fund has indicated that a significant share of Côte d'Ivoire's total external debt is private sector debt to private entities abroad, which carries no government guarantee. (Only highly approximate information is available on this debt: it is projected to be equivalent, in net present value terms, to about 80 percent of exports at the completion date). In the earlier analysis, while this component of debt was included in the total, no action on this debt per se was assumed. However, since the assessment of debt sustainability was based on the total external debt, the burden of debt relief proposed to reduce the net present value of total debt-exports to 200 percent by the completion date fell on the public sector creditors.

In contrast, the technical note assumes, in all cases, that debt sustainability is assessed with respect to public and publicly guaranteed external debt; private sector debt owed to private sector creditors is excluded from this analysis. Public and publicly guaranteed external debt comprises the vast bulk of total external debt in all of the HIPCs except Côte d'Ivoire, and to a lesser extent, Niger. On this basis, there would be no costs associated with Côte d'Ivoire in the framework of the costings exercise. This is because Côte d'Ivoire's net present value debt-exports ratio for public and publicly guaranteed external debt is projected to fall below 200 percent at its hypothetical completion date in the year 2000, after assuming a stock-of-debt operation on Naples terms from bilateral and commercial creditors for such debt (as outlined in Box 2 of the technical note).

The exclusion of Côte d'Ivoire from the costings estimates led to a downward revision of the total potential costs to US$5.6 billion as presented in the technical note. This revision affects only the costs to bilateral and commercial creditors. The projected costs to multilaterals under the initiative, including the costs to the Fund, are not affected as no action had been projected to be required of multilaterals in the case of Côte d'Ivoire. This applies to the costings under both the 90 percent net present value reduction assumption and the illustrative assumption of an 80 percent net present value reduction for bilateral and commercial creditors.

Another difference between the ESAF financing modalities paper and the technical note relates to the projected costs to the Fund under the proposed initiative. The technical note expresses the cost to the Fund in U.S. dollars and in net present values at end-1996 (US$0.5 billion under the 90 percent net present value reduction assumption for bilateral and commercial creditors), while the ESAF financing modalities paper expresses the cost to the Fund in SDRs and in net present values at end-2000 (SDR 0.55 billion under the 90 percent net present value reduction assumption). The ESAF financing modalities paper adds a margin of about 20 percent to the projected costs to the Fund to provide some allowance for inherent uncertainties in the costings estimates.

The question and answer brief on the framework for action to resolve the debt problems of the heavily indebted poor countries (SM/96/81, Sup. 1, 4/4/96) presented an earlier estimate of the potential total costs of the proposed initiative of US$7–8 billion, in 1996 present value terms. This figure excluded any costs associated with Côte d'Ivoire, in line with an earlier debt sustainability analysis which projected the net present value total debt-exports ratio (including private sector debt) to be less than 200 percent by Côte d'Ivoire's hypothetical completion date, after assuming a stock-of-debt operation on Naples terms from bilateral and commercial creditors (see EBS/96/190, 11/27/95). The net present value total-exports ratio for Côte d'Ivoire was revised significantly in the updated debt sustainability analysis, and was projected to be above 200 percent by the completion date (see EBS/96/83, 5/30/96). This revision results from assuming that a greater proportion of the sizable private capital inflows projected for the next 4–5 years would be debt creating flows, rather than foreign direct investment as has been earlier assumed.

The revision to the total costings figure as presented in the technical note arises from the availability of new or updated debt sustainability analysis for a number of countries, particularly Ethiopia and Nicaragua (the debt sustainability analysis for Nicaragua has not yet been presented to the Executive Board). The costings for Ethiopia and Nicaragua were revised downwards significantly, mainly due to the assumption that the terms of Nicaragua's recent provisional agreement on debt to the Russian Federation (which involves an net present value reduction of about 90 percent) would be implemented in Nicaragua and similar terms agreed for Ethiopia, irrespective of the initiative. The earlier analysis had assumed an net present value reduction of 67 percent on this debt, in line with Naples terms, in the absence of enhanced action under the initiative.

The recent revisions to estimates of the potential costs of the proposed initiative highlight the preliminary nature of the costings and the large variability of possible revisions. Given the uncertainties involved, particularly in making projections for up to six years hence, these costs can only be considered broad orders of magnitude. It is possible that future estimates of the costs will differ significantly from the latest estimates as the proposed initiative evolves and as new and updated debt sustainability analyses become available. The introduction to the technical note (SM/96/127, 6/4/96) emphasizes these uncertainties and outlines some factors that will affect the final costs associated with the initiative; the note also contains some sensitivity analysis (section IV) showing the effects on costs of different key assumptions.

Mr. Schoenberg made the following statement:

Germany, as all other Fund members, is committed to the continuation of ESAF. We believe this can be achieved without selling gold and/or using funds from the General Resources Account.

Our opposition to the sale of gold and/or the use of GRA resources to finance a continuation of ESAF is based on our understanding of the basic principles of the Fund as a monetary institution. In view of the extraordinary large commitments the Fund made during the past 18 months, gold sales would not only send a wrong signal to markets and member countries; this would be also an inappropriate time to weaken the Fund's financial basis by diluting its reserves.

As for the use of GRA resources, it was recognized by the majority of Fund members at the time of the inception of the ESAF instrument that extended periods of lending with a strong concessionary element precluded the use of monetary resources. We see no reason to give up this principle now, all the more as demands for lengthening ESAF repayment periods put forward in the context of the HIPC-initiative could set ESAF lending even further apart from the Fund's regular operations. Resource transfers should be financed through bilateral contributions by donors and not through monetary resources of the Fund provided by central banks.

In principle we see two possible options, one including the establishment of an interim ESAF, the other without an interim ESAF. The financing proposals for the two options presented in this paper would allow average annual commitments of SDR 0.8 to 1.0 billion after the end of the current ESAF. These amounts are of a similar magnitude as the ones proposed by the staff in recent papers.

In light of recent experience with ESAF disbursements, it is realistic to assume that the funds currently available under ESAF will be sufficient at least up to the end of the year 2000; current funds may even last up to the end of 2001. This is consistent with the fact that staff projections of future demand for

Fund resources are always on the high side, which is completely appropriate from the staff's point of view.

Hence, we propose to extend the current ESAF to the end of the year 2000 or 2001 and to set up a self-sustained ESAF beginning in 2004. Consequently, the interim ESAF would be created for the period from the beginning of 2001 or 2002 to 2003. Our proposal comprises the following elements:

OPTION I

1. A stretching of current ESAF resources by one year to end-2000 would permit annual disbursements of SDR 0.94 bn.

2. Interim ESAF

Capital: to be derived exclusively from bilateral contributions with adequate involvement of financially strong Fund members; Germany is willing to make an appropriate contribution.

Interest subsidy: from the use of SCA-2 resources and bilateral contributions. SCA-2 resources could be used in different ways depending on whether a contributing country re-transfers its SCA-2 share as a grant or as a non-interest-bearing loan. Bilateral contributions would be expected from financially strong Fund members which contributed less than proportionate to SCA-2 and from countries that are unable, for legal reasons, to re-transfer their SCA-2 share to the Fund (the staff proposals also assume bilateral contributions).

Interest income on SCA-2 funds alone would suffice to subsidize a yearly commitment of 0.59 bn SDR from 2001 to 2003. An additional interest-free deposit of 0.47 billion SDRs at the beginning of 1997 would generate enough additional interest subsidies to provide an annual commitment level of SDR 1.0 billion from 2001 to 2003, the same yearly amount as proposed by the staff for the interim ESAF. We can assume from previous discussions and indications from member countries that it should be possible to raise such amounts. Germany is willing to retransfer its SCA-2 reimbursements as a virtually interest-free loan to the Fund for this purpose.

3. Self-Sustained ESAF

According to staff calculations, a self-sustained ESAF beginning in 2004 would allow for annual commitments of SDR 0.8 billion.

OPTION II

The alternative option would be not to establish an interim ESAF at all. This could become necessary if bilateral contributions for interest subsidies could not be mobilized to the extent necessary. In this case, ESAF should be financed as early as from 2002 by releasing funds from the ESAF Reserve Account into the Special Disbursement Account. Since the ESAF Reserve Account was established to protect creditors to the current ESAF, this protection would instead be provided by an appropriate Fund gold pledge. In addition to the SDA resources, interest earnings from redeposited SCA-2 resources would have to be used, too. This alternative would also, like Option 1, allow a self-sustained ESAF to operate with annual commitments of up to SDR 0.8 bn. Annual commitments of SDR 0.78 bn would be available until end 2001 by stretching current ESAF resources by two years.

HIPC Initiative

Regarding the proposed framework for resolving the debt problems of the heavily indebted poor countries, we take note of the staff's submission that any estimate of the possible costs to creditors of the proposal at this stage must be regarded as subject to wide margins of error. As I have stated before, the new and eventually self-sustained ESAF will be the vehicle through which the Fund may participate in the HIPC Initiative. This will be on a as-needed and case-by-case basis, taking into account the development of economic factors. Since the numbers are so highly insecure, we do not feel it to be necessary or even desirable to set aside certain amounts per year for the resolvement of such debt questions, but rather expect to make use of the average annual availability of ESAF resources in a flexible manner, prioritizing the use of these resources if that should become necessary. Concerning the staff paper on this issue, I would just like to draw attention to the fact, that if in the proposed framework net present value debt-export ratios were reduced to 225 percent rather than the 200 percent assumed elsewhere in the staff paper, the total cost would be reduced by one-third.

Mr. Barro Chambrier, speaking on behalf of Mr. Koissy, made the following statement:

Given the structural nature and the magnitude of the problems facing low-income countries, it is reasonable to assume that ESAF resources will be needed for an extended period of time. Recognizing this need, the main question is to determine the best way to secure the future availability of ESAF resources in light of projected external financing requirements of low-income countries.

While these countries must reinforce their adjustment policies, at the same time a bold and more imaginative approach to the problems of low-income countries is urgently needed on the part of bilateral and multilateral agencies. In that context, the Fund is certainly challenged in its catalytic role in international finance. Here, the resources available under the Enhanced Structural Adjustment Facility will remain the principal instrument of Fund's intervention in these countries. Because of that, it is important that firm assurances be made on the future availability and adequacy of these resources.

The staff paper presents a variety of financing options, which seem to differ mainly on the basis of assumptions made regarding the sources of loans to finance the principal and the sources of subsidies in ESAF operations. However, it is our view that staff projections underestimate the potential demand for ESAF resources, because they are based on optimistic assumptions concerning the growth rates of the export volumes of low-income countries. Moreover, we note that according to some recent studies on the impact of the Uruguay Round on some developing countries' exports, these projections have become even more difficult to carry out.

Assuming with the Managing Director that modified Option 1 or 1(a) would represent the "best" solution to the issue of ESAF financing, the main issue of interest to the users of ESAF resources is whether ESAF resources will continue to be available in the future at an amount sufficient to meet the financing needs of low-income countries. The adequacy of the level of future ESAF resources needed to respond to the demand of these countries is not easy to determine. In projecting the financing requirement for ESAF, it would be useful to take into account a number of factors, including the fact that official development assistance by many donor countries has been on a steady declining trend in recent years. In addition, the recent joint study by Fund and World Bank staff, based on optimistic external trade scenario, indicates that about 20 low-income countries will continue to have an external debt burden that is unsustainable over the medium term and beyond.

All these factors taken together tend to indicate that the amount of ESAF resources needed in the future should be considerably higher. At this stage, there seems to be a consensus that the minimum amount that should be available annually in Option 1 or 1(a) of a self-sustained ESAF is SDR 820 million. One should assume that this amount is also required for the Fund to continue to play an effective role in low-income countries during the period after 2005. Any amount below SDR 820 million will hamper the ability of the Fund to assist a broad segment of its membership.

The next issue to be addressed is the impact that the upcoming debt initiative for some eligible heavily indebted poor countries by the Fund and the World Bank is likely to have on the financing of ESAF operations.

On the link between the HIPC debt initiative and ESAF resources, it is important to indicate that the total cost of the debt initiative will depend on the number of eligible countries and the timing of their eligibility. In that connection, one could wonder whether the artificial distinction between countries with "unsustainable debt burden" and those "possibly stressed" does not unduly keep the number of eligible countries low. The same question could be raised regarding the need to have a "two stage" approach before a country can qualify for the HIPC debt initiative.

If a link is made between ESAF and the financing of the debt initiative, at this stage it seems difficult to see how the projected resources for a self-sustained ESAF could be maintained at the floor level of SDR 820 million per year. As illustrated in Table 2 (page 8 of the staff paper), Fund's involvement in the proposed HIPC debt initiative will considerably reduce the level of resources available for the financing of a continuation of ESAF operations.

Without the debt initiative, SDR 820 million would become annually available under a self-sustained ESAF beginning in 2005. However, if bilateral and commercial creditors grant a 90 percent reduction of the net present value of their claims on the low-income countries involved in the initiative, the Fund will have a cost of SDR 550 million in the initiative and the level of resources available annually under a self-sustained ESAF will fall to SDR 700 million. The cost to the Fund increases to SDR 850 million, if the debt initiative results only in a reduction of 80 percent of the net present value of bilateral and commercial creditors' claims on the HIPCs. In that case, the level of resources available annually under a self-sustained ESAF falls very low, i.e., to SDR 600 million.

In conclusion, if one accepts the view that the annual amount of SDR 820 million that would be available without the debt initiative is the minimum required for the Fund to play a meaningful role in addressing the imbalances facing low-income countries, to have a self-sustained ESAF that provides annual resources below that level is worrisome. To avoid such a situation, it seems appropriate to argue in favor of an amount of gold sales by the Fund much higher than the 5 million ounces proposed by the Managing Director. In addition, the Managing Director's proposal to raise additional resources from other sources, including increased bilateral contributions deserves the full support of the entire membership of the Fund.

Mr. Clark made the following statement:

My authorities and I would like to thank the staff for the impressive body of work they have undertaken in the past few months in response to the Interim Committee's request regarding financing proposals for ESAF and contributions to the HIPC Initiative. As our exploration and negotiations have reached a fairly advanced technical stage, I think the simplest approach is to respond to the Issues for Discussion as laid out clearly on page 21 of the staff paper.

This chair's position on new bilateral assistance, either in the form of grants or interest-free loans, is well known. While we would not want to discourage others as regards grants, it is clear that bilateral loans to finance the principal component of ESAF loans will necessitate a sizable gold pledge, unless creditors accept reserve coverage at less than 100 percent. We would prefer to have reserve coverage at, or close to, 100 percent. We also prefer the certainty of a small sale of gold—which preserves the principal of the original asset—over the probability of loss of a large gold pledge. Therefore, in order to avoid making a big gold pledge, a further round of bilateral lending is less attractive: GRA resources and gold sales are a better source of financing for the principal and subsidy elements respectively.

As regards "GRA-sunsetting," there are clear advantages and disadvantages. On the one hand, it is wise to plan conservatively. Our experience with ESAF shows that successive years of comprehensive and deep structural reforms are required to raise real incomes significantly in low-income countries. Hence, we are likely to need ESAF for some time to come; exhausting SDA resources by sunsetting may lead to higher costs down the road.

On the other hand, faced with an impasse that could jeopardize continued ESAF, securing financing for ESAF for another 20 to 30 years could arguably be seen as practical public policy. For one thing, we cannot accurately predict ESAF financing requirements in the year 2030. It is also possible that traditional ESAF creditors will be in a more favorable fiscal position at that time, and that new contributors will emerge by then; in which case, depleting SDA resources becomes less of a concern. Finally, sunsetting provides us with enough resources to meet demand over the next 20 years (under the staff's assumptions).

On balance, sunsetting represents a sub-optimal solution, but should remain on the table as a practical compromise possibility.

The priority issue today is to secure financing for a continuing ESAF. A rough estimate of our contribution to the HIPC Initiative is important in this respect, although the actual modality of the Fund's contribution is less critical at this stage than resolving the ESAF financing quandary. However, since Governors have asked to see specific proposals on the matter by the Annual Meetings, this is a good opportunity to express our preliminary views on the options presented.

In our view, the escrowed loan and escrowed grant proposals provide the best options. Between the grant and the loan, the escrowed grant is preferable since it (1) provides the simplest facility which clearly reduces the net present value and the face value of outstanding debt; (2) may be easier to administer; and (3) most important, requires a smaller withdrawal from the SDA than the loan modalities. The latter factor minimizes the negative impact of the debt initiative on all ESAF borrowers, including low-income countries not heavily indebted. Could the staff indicate if this approach is more consistent than the others with the proposed Multilateral Debt Trust Fund under consideration at the World Bank?

The staff has chosen the escrowed loan because it smooths out the HIPCs' repayment schedule, reducing debt service in the earlier years but stretching it out longer. While we could also support the escrowed loan option, it would be interesting to hear the preferences of the HIPCs on debt service profile.

The staff's preliminary cost estimates for the HIPC Initiative appear reasonable and take into consideration, as well as is possible, the array of factors that could affect the eventual costs associated with the initiative. However, my authorities continue to object to the assumption of 90 percent net present value debt reduction by the Paris Club and the residual role assigned to the multilaterals in the whole debt reduction exercise. Nevertheless, for our present purposes, which are to incorporate a broad estimate of the total potential cost into our financing projections, the numbers serve as an acceptable basis from which to proceed.

After seeing the costs associated with the HIPC Initiative, the need for additional resources becomes even clearer. Given the difficult fiscal situation facing many members, it is essential that we use existing resources as effectively as possible. It is worth recalling that the original objective of this exercise was to assist low-income countries by putting ESAF on a more extended, possibly self-sustained, basis. Indeed, the Interim Committee Communiqué from last October welcomes specifically the "consensus in support of continuation of ESAF, including the establishment of a self-sustained ESAF." Accordingly, after reviewing all the constraints and trade-offs, the option which comes closest to my Authorities' position is an amended Option 1 with gold sales financing all of the subsidy.

The Director of the Policy Development and Review Department, responding to Mr. Schoenberg's statement, noted that under the Managing Director's proposal, only the investment income from the profits of gold sales would be used. Thus, the corpus of the profits from the sale of gold would remain intact and the capital base of the Fund would not be weakened. Whether a diversified portfolio consisting of investment income and gold was preferable to a portfolio comprised only of gold was open to discussion. The Managing Director considered that, by assisting the low income countries, the Fund would not only be strengthening their economies, but would also be strengthening the portfolio of the entire institution. Mr. Schoenberg had also noted that lengthening the maturities on ESAF loans to the heavily indebted poor countries would alter the monetary character of the institution. It should be borne in mind, however, that loans to the HIPCs would not be financed through either GRA resources or bilateral loans. The proposal was to lend SDA resources at longer maturities, which would not have an adverse impact on the monetary character of the institution. Mr. Schoenberg's proposal envisaged lower levels of ESAF lending for the period 1996–2004 than the staff's projections of demand for that period: under Option 1 of his proposal, lending would be 13 percent lower, and, under Option 2 of his proposal, lending would be 28 percent lower. The staff's projections had been considered by the Board on several occasions, and the Board had endorsed the estimates on which the Managing Director's proposal was based. Furthermore, ESAF lending for the first six months of 1996 was consistent with the staff's estimates of demand for the 1996–2000. For the period 2000–03, Mr. Schoenberg's proposal envisaged bilateral contributions of SDR 1.3 billion, compared to the Managing Director's proposal of SDR 1.05 billion. Finally, the cost of the debt initiative to assist the heavily indebted poor countries had not been incorporated into Mr. Schoenberg's proposal.

Mr. Schoenberg remarked that the issue was not one of reserve management, but of reserve use. While converting a portion of the Fund's gold stock would maintain the nominal value of the Fund's capital, its real value would be eroded. He was concerned by markets' reaction to the sale of gold by the Fund. Markets would not perceive gold sales as a change in the composition of reserves; rather, they would look upon it as a way of transferring Fund resources to a group of countries, which would result in an erosion of the Fund's capital base. Moreover, if selling gold was a preferred form of asset management, he wondered why the United States held a portion of its reserves in the form of gold.

The Chairman recalled that ten years ago, 26 countries had been in arrears to the Fund. At present, the number of Fund members in arrears was substantially lower. That was partly due to Fund support to low-income countries through the ESAF. He was proposing that the Fund continue with the ESAF in order to assist the most heavily indebted of those countries. While he would prefer that the Fund not sell gold, if the sale of a limited amount of gold and the income from investment of the profits from such sale could contribute toward lowering the debt burdens of the heavily indebted poor countries, it should be done.

Mr. Schoenberg said that he agreed fully with the Chairman on the purpose of the ESAF. Indeed, he had stated that Germany remained committed to the ESAF. However, he considered that the Fund's credibility would be enhanced if the ESAF were financed through bilateral contributions, in the recognition that the Fund's own resources were inadequate to finance a continuation of that much-needed instrument.

The Chairman observed that, while he would welcome further bilateral lending for the ESAF, some members had expressed the view that they would not be in a position to make bilateral contributions for the ESAF.

Ms. Lissakers noted that the United States kept a smaller proportion of its reserves in the form of gold than the Fund. Indeed, the United States had monetized a portion of its gold holding by issuing gold certificates, thereby converting gold stocks into an income-earning asset. On the use of the Fund's gold, she wished to emphasize that the proposal included "ring fencing" of the investment income from the profits after it was no longer needed to finance the ESAF subsidy. In contrast to Mr. Schoenberg, she considered that the Fund's resources were adequate to ensure a continuation of the ESAF. Gold was part of the Fund's asset base and should be mobilized. Use of gold as envisaged under the proposal would be consistent with the monetary character and the objectives of the institution.

Mr. Shaalan made the following statement:

> Let me at the outset say that this chair has a definite preference for modified Option 1, for the reasons summarized in your statement of May 16. Our reservation with regard to modified Option 1(a) is based on the fact that in addition to the proposed gold sale for subsidies it would also require, as we understand it, a very large gold pledge as protection to bilateral contributions for the loan component. If, however, the provision of such a gold pledge could be avoided, we would favor modified Option 1(a), since it would have the added advantage of not requiring the buildup of precautionary balances associated with the use of GRA resources.
>
> Our primary reservation with regard to modified Option 2 lies in the fact that the early use of SDA resources for subsidies entails a serious reduction in possible annual commitments under the self-sustained ESAF to about SDR 0.66 billion, beginning in the year 2005. In view of the projected resource commitments of ESAF-eligible countries, not to mention the preliminary cost estimates of the HIPC Initiative, this would clearly be totally inadequate. In addition, under this option a gold pledge of over 4 million ounces would be required if the full protection accorded to ESAF creditors were to be restored. We are of the view that the sale of a modest amount of

gold—and here I would like again to reiterate what this chair has proposed earlier, what we mean by "a modest amount of gold;" namely, between 5 and 10 million ounces—while preserving the profits as parts of the Fund's capital, modified Option 1, would be more prudent than the provision of a gold pledge, modified Option 2, which in case of activation would represent using up part of the Fund's capital. Needless to say, the resources being made available for ESAF under Option 4—which we totally rule out because the resources under that option are far too inadequate if compared to the amounts needed—has the added disadvantage of requiring a large gold pledge.

I find Mr. Schoenberg's suggested first option very interesting. As the staff notes, it can cover up to 87 percent of the estimated commitment. With that exception—that we would want 100 percent of these commitments fully financed—I would find Mr. Schoenberg's proposal very interesting. As we heard from the Managing Director yesterday over lunch and again today, we are most unlikely to get the full amount for both principal and subsidies from potential creditors. Hence, while the proposal is good, from what I have heard from the Managing Director over the past several months—who I believe he would be the first to support it—bilateral contributions are unlikely to be forthcoming for both the principal and subsidies. Thus, this would not be a viable option at this stage. Moreover, I would be interested in the staff's comments on the effect of "stretching" present ESAF resources beyond 1999, on the assumption that the self-sustained ESAF could begin in 2004 without a gold pledge, which I believe is implied by Mr. Schoenberg's first option. It is our understanding that a gold pledge would be needed for early transfer of resources from the ESAF Trust Reserve Account to the SDA.

Turning to the issue of self-sustaining ESAF versus the GRA sunsetting option, I would suggest that we limit our deliberations at this stage to the interim ESAF; that is, the period between 2000 and 2004. I see no pressing reason to take decisions for the period beyond those dates. The decision on the issue of self-sustaining ESAF versus the GRA sunsetting option could be taken at a later stage, and I believe any detailed discussion of that would further complicate our discussions on this subject.

On the HIPC Initiative, we can go along with the preliminary cost estimates of the Fund's participation in the proposed initiative, while cautioning that these should be considered minimum estimates in view of the optimistic assumptions that have been made in staff calculations. I have in mind, in particular, the export projections. We would agree that an escrowed loan on extended maturities would be the preferable financing modality for the Fund's participation in the initiative.

Finally, as I mentioned during yesterday's lunch, I would like to inform the Board that I have received responses from eight of the nine contributors to SCA-2 from my constituency indicating their agreement to the use of the investment proceeds of any SCA-2 refunds for ESAF subsidies. I am still in touch with member number nine, hopefully to get a positive reaction.

Mr. Mesaki made the following statement:

I would like to begin by commending the staff's effort in preparing this new paper, which provides us with an estimate of the cost of the HIPC Initiative and its impact on the ESAF operation.

Our position on the issue of the ESAF financing modality has not changed since the spring Interim Committee: that is to say, we oppose the sale of the Fund's gold, and we believe the staff has overestimated the demand. Having said that, let me comment on the issues for discussion.

First, regarding a further round of bilateral lending to the ESAF Trust, we are open to GRA financing of ESAF. As GRA resources are used for 10-year maturity loans under the Extended Fund Facility (EFF), we do not think that use of the GRA for ESAF loan principal will significantly change the Fund's character. That said, if a majority supports the options with further bilateral lending and a continuation of the trust method, under the condition that sufficient protection for lending principal is assured, there is a possibility that Japan will continue to contribute to the loan principal.

Regarding the issue of reserve coverage, it should be taken into account that the risk to ESAF lending will be magnified because the use of ESAF by post-conflict or arrears countries will increase.

Let me turn to the issue of GRA sunsetting. This would permit a larger lending capacity than would a self-sustained operation. Moreover, the operation could be more flexible under this option than under a self-sustained ESAF. I do not think that it is necessary to have a self-sustained ESAF. In any case, we will keep an open mind until more specific proposals on this issue are presented.

Regarding the cost estimate for the HIPC Initiative, I would first like to thank the staffs of the Fund and the Bank for preparing the detailed technical note. Let me reiterate that the results of the estimate and all assumptions made with regard to the estimate should be interpreted as being just for illustrative purposes. The results must not prejudge our discussion of the HIPC Initiative.

In this respect, further calculation based on different assumptions for the operation targets on the completion date should be prepared. The criterion of 200 percent of the ratio of net present value of debt outstanding to exports is, in my view, too generous. I would like to know the implications of adopting the criteria of 250 percent of the ratio of net present value of debt to exports and a 25 percent debt service ratio. As we should first focus on the countries that are suffering the most severely, that is to say, those whose debt burden has been classified as unsustainable, we need cost estimations based on stricter criteria.

As for the use of the SDA for the Fund's contribution to the HIPC Initiative, this is an option we can explore. However, further discussion on the initiative itself is needed, especially on the appropriateness of the assumptions on debt reduction by bilateral creditors and the feasibility of debt reduction by other multilateral institutions. Especially as the Paris Club has already made a continuous effort to help heavily indebted poor countries, and 67 percent debt reduction is already a heavy burden, we do not believe that 90 percent debt reduction by the Paris Club is reasonable. Also, I wonder to what extent regional multilateral development banks, especially the African Development Bank, can contribute to this initiative without compromising their financial integrity.

As for the specific modality through which SDA resources are utilized for the HIPC Initiative, either modality 1 or modality 4, namely, an escrowed loan or the refinancing of matured loans seems appropriate.

Finally, regarding my preference among the options, even after taking the cost of the HIPC Initiative into account, my position has not changed. Options 1 and 1(a) are not acceptable to me. We should explore a solution to this issue in line with Options 2, 2(a), or 4(a).

It is a welcome development that a significant number of countries have expressed today their intention to make bilateral contributions. On this occasion, I would like to convey my authorities' intention to make an adequate contribution in the context of fair burden sharing, provided we can reach consensus on a financing modality that is in line with a non-gold sale option, namely, Options 2, 2(a) or 4(a). As many developing countries have indicated their intention to contribute, I strongly hope all the major developed countries will make appropriate bilateral contributions.

The Chairman welcomed Mr. Mesaki's statement that Japan was willing to contribute to a continuation of the ESAF, as it had done in the past. With respect to debt relief by the Paris Club, he hoped that bilateral creditors would show the flexibility needed in order to alleviate the debt burdens of the heavily indebted poor countries. A full 67 percent net present value debt reduction was a significant contribution; however, he would hope that the Paris Club creditors would be willing to allow an even greater reduction in the net present value of debt. As to the role of the Fund, it should be borne in mind that, as a preferred creditor, the Fund's involvement could not precede action by bilateral creditors.

Mr. Schoenberg noted that Germany, too, was willing to contribute to the ESAF. He wondered whether other members had indicated their willingness to contribute to the ESAF and whether bilateral contributions would be sufficient for the loan component or for the subsidy component.

The Chairman remarked that most of the responses he had received had been from developing countries. That was a welcome development, because it would ensure that the universal character of the ESAF was maintained. While he had received specific commitments from developing countries, the same was not true of the responses from industrial countries. It would be inappropriate to indicate the precise amounts that had been committed thus far, until he had received specific responses from a broad cross section of the membership. It would be necessary to raise bilateral contributions to finance the loan component, if the Board agreed not to use GRA resources. Japan had indicated its willingness to contribute to the ESAF, and he was confident that other countries would also be willing.

Mr. Wijnholds made the following statement:

> The Interim Committee has provided us with a clear mandate to come up with specific proposals by the time of the Annual Meetings for both the continued financing of ESAF and the HIPC Initiative. I welcome the fact that the staff's work has progressed so far that we can now evaluate the various alternatives for the financing of ESAF and the HIPC Initiative together. I also sincerely hope that some progress can be made in today's discussion. A long continuation of a lack of consensus among the Fund's membership on this highly publicized issue will not do us any good.
>
> On the issue of the interim ESAF, I can be brief. In my view, Options 1 and 1(a) are clearly preferable, as these deliver the highest level of annual commitments under the self-sustained ESAF. I would have a preference for financing the principal through loans from ESAF creditors—that is, Option 1(a)—but not to the extent that I would be willing to extend an additional gold pledge. Should ESAF creditors prove unable to accept the reduced level of guarantees resulting from the additional ESAF loans and the HIPC Initiative, I am willing to revert to Option 1 to limit the reduction in guarantee level. However, this is as far as we should go. My authorities remain opposed to additional gold pledges, as this entails the risk that the corpus of the profits would need to be used. They also question the rationale for a 100 percent guarantee on ESAF loans.
>
> I turn now to bilateral contributions for ESAF subsidies. The Netherlands is willing to contribute toward the required subsidies, and I would take it that its contribution would take the form of a direct subsidy. However, this contribution is made conditional on an equitable burden sharing. It has not been spelled out what it exactly means yet. But, certainly, it is clear that, as other countries have stated earlier or will probably still state today, there has to be something of an equitable burden sharing there.
>
> Other members in my constituency are still contemplating the issue. However, as most face considerable external challenges themselves, I would not expect too much from them in this area, but I will try. Incidentally, I believe that, while I understand that management wanted to reach as large a number of countries as possible, my Bosnian authorities were a little puzzled when they got an invitation to contribute to the ESAF.
>
> On the self-sustained ESAF and sunsetting, we sympathize with those who wish to obtain a constant level of annual commitments under the interim and a self-sustained ESAF. However, my authorities have severe problems with a solution along the lines of the sunsetting proposal. GRA resources, they feel, ought not to be used for ESAF operations on a long-term basis. ESAF operations have a higher risk profile and are characterized by a larger share of repeat users. Use of GRA resources for ESAF operations on a long-term basis

would be at odds with the monetary character of the Fund as it would undermine its liquidity. We have only been willing to accept a temporary use of GRA resources in a spirit of compromise. There are also other problems with the sunsetting proposal. It requires the use of the corpus of profits on earlier gold sales, which, by the way, bodes ill for the preservation of the corpus of the gold sales proposed at present. More generally, it implies a shift in the burden of the present generation of policymakers to the next, something we often criticize in other policy areas.

I turn now to the HIPC Initiative. The costing paper provides valuable information on the possible size of the problem. The staff underscores the large measure of uncertainty that surrounds the forecasts. In general, the assumptions seem quite cautious, in the sense that they aim to prevent further unpleasant surprises, such as in the area of eligibility, the timing of completion dates, the use of the 200 percent threshold, and so on. For other risks, the staff presents a sensitivity analysis. I believe it would be useful to continue with the sensitivity analysis in future papers, given these uncertainties. For instance, the envisaged 90 percent stock of debt treatment by the Paris Club does not seem assured. While I have expressed some support for that level, we have to be realistic, as clearly there are some problems there. Moreover, there is sometimes some difference of view on export projections—a topic, clearly, that even reasonable people can have different views on. Let me also say that the decision to distribute debt relief among multilateral creditors in accordance with exposure at the decision point instead of the completion point makes sense as it prevents difficulties in financing the second qualification period.

I also have a question on the HIPC Initiative. The debt relief initiative assumes a significant contribution from the other multilateral institutions. In fact, their contribution is expected to exceed the one from the Fund. Half of this contribution from these others is expected to come from the African Development Bank, and the other half, about US$400 million, from a very diverse group of multilateral creditors. Could the staff give us any indication of what contacts there have been with these creditors and what their initial reaction has been?

Finally, on the modalities of the Fund's contribution to the HIPC proposal, the staff proposal to use the SDA to finance the Fund's contribution would seem appropriate. As the staff points out, there are various ways to arrive at the necessary level of debt relief. I agree that modalities three and four are inferior and do not need to detain us further. Options 1 and 2 both have their attractions. These are the escrowed loan and the escrowed grant. The staff has a clear preference for the escrowed loan approach, and I understand the arguments. However, I would not like to rule out the escrowed grant approach at this stage. Indeed, Mr. Clark in his statement has put forward a number of arguments in favor of the grant approach. I would add as an argument that with the escrowed grant the Fund makes a transparent contribution to the HIPC Initiative, and this, I believe, is an advantage from a public relations point of view, which I think is not unimportant in this whole exercise. It also has the lowest impact on the annual commitments under the self-sustained ESAF. I accept that it would provide less scope to address the liquidity problems of the HIPCs. However, this issue should not be judged in isolation, but needs to be evaluated against the background of the whole debt relief operation. I would be interested in staff comments on this matter.

Mr. Evans made the following statement:

I welcome the papers we are discussing, and the hard work that lies behind this by the staff, and, indeed, the close cooperation that is going on with the Bank. I do believe that we are making progress in responding to the agreements at and the directions from the interim and development committees.

The paper on costings demonstrates that the cost to the Fund of participating fully in the debt initiative will be manageable. It seems to me that between now and the Annual Meetings we have to do three things: we have to settle the mechanisms by which the Fund contributes to the debt initiative; we have to settle the source of funding for that initiative; and we have to agree on how to finance a continuing ESAF. Of course, in my view—and I think it is now widely agreed—the second and third of these, settling the sources of funding for the debt initiative and for the continuing ESAF, are inextricably linked.

I will repeat something of what I said yesterday at lunch. At the World Bank Board on Monday, the President proposed a contribution of US$500 million from net income for FY96 as a significant down payment for the Bank's contribution to the debt initiative, to be followed by further sizable contributions from future years' income. This contribution by the Bank would be contingent on participation by other creditors, particularly in this context, including this institution, the Fund. Most Directors, or those who spoke, welcomed the proposal from the President as a good start by the Bank in demonstrating its commitment in this area. Quite a number of us argued that the assumption that the Paris Club would increase its debt relief to 90 percent was unrealistic and, more fundamentally, that the residual model, whereby the international financial institutions contributed only after further bilateral action, was not acceptable. A number of Directors continued to argue that six years would be too long in some cases. Let us recall that the Interim and Development committees in April endorsed the debt initiative. I think the onus is now on this institution to decide how to make its contribution. I have to say that the World Bank is now well ahead, but it cannot and will not act without the Fund.

On the debt initiative, I believe we still have to make it clear that six years is too rigid a formula. We do need greater flexibility so that the case of good track records can be recognized by shorter periods. We do need to do this—and several speakers have already said this—case-by-case approach, without any kind of prescribed list at the outset. I for one was surprised to see that the track record of economic performance built by Mozambique over the past three or four years was assumed to count for nothing under the initiative because it had gone off track. I think we have to find some way of looking flexibly at track records. That is not a plea for debt relief at any cost; it is a plea to say that we have to look at a track record, taking account of commitment and of actions, and not be rigidly bound by one particular time frame.

The United Kingdom continues to argue that the Paris Club should be prepared to go beyond Naples terms where necessary, but I think that 80 percent reduction probably represents the top end of the realistic scale of possibilities. Of course, we need to explore not only higher levels of debt relief but also wider coverage. It might be helpful at some stage if the staff were to say a bit more, or perhaps circulate a short paper, on the existing mechanisms at the Paris Club. People talk about 67 percent relief, whereas we know that, in effect, it is equivalent to a substantially smaller amount, given the limited coverage of the debt covered. It is also important—and Mr. Clark makes this point—that the Paris Club should not be seen as the first port of call, with the international financial institutions picking up the residual. Instead, I think the cost to the Fund should be calculated assuming that, once a country has benefited from Naples terms, the cost of reaching sustainability is based on roughly proportionate burden sharing between all creditors, which seems to me to mean parallel and coordinated actions. I believe this is consistent with the preferred creditor status of the Fund, because the Paris Club will be providing 67 percent, or more, debt relief and then there will be parallel action by all creditors to sort out the remaining problem.

The paper on debt costings suggests that at the completion date the 200 percent debt/export ratio is simply illustrative and, indeed, there may be a higher target in some cases. Mr. Mesaki wanted to go as high as 250 percent on this. I think what we are trying to do here is provide countries with a permanent exit. This means doing more than the bare minimum. So I am against raising the bar beyond 200 percent.

On ESAF, the United Kingdom continues to have a very strong preference for gold sales as the main source of finance. We would prefer a variant of Option 1, with sale and reinvestment of gold. We could go up to 8 million ounces, depending on the level of bilateral contributions. The staff paper and Mr. Schoenberg's statement are helpful in demonstrating that, in the absence of gold sales, it is not really possible to achieve a sufficient ESAF, including adequate provision for the Fund's participation in the debt initiative. Table 2 on page 8—which I use for illustrative purposes because it assumes a reduction of 80 percent by the Paris Club—demonstrates that Option 4(a) or Option 2(a) or 2 produces a very low level of possible commitment to ESAF in the period beyond 2004. Let us recall that even an ESAF of 0.8 billion a year from 2004 onwards would represent a fall of 40 percent in real terms compared to where we have been recently. I wonder whether the staff could tell us now, or perhaps later, what level of ESAF Mr. Schoenberg's proposal would provide for when the cost of the HIPC Initiative is allowed for.

On the issues raised on ESAF financing on page 21, I have the following comments. We would not want to preclude lending from the GRA in order to meet the needs of the debt initiative, provided we can come to some agreement on the degree of protection. On sunsetting, we are not against it, in principle, if that is necessary in order to secure a substantial ESAF for a good period ahead, but I agree with your statement that this is not something on which we have to make a decision right now.

On the debt initiative, the Fund clearly has to find a way of contributing. It seems to me that an escrow loan on extended maturities would be the preferable financing modality. I believe that Directors who find this option unattractive need to come up with a better alternative. On the cost estimates for the Fund's participation, the paper is very helpful in identifying what is clearly a wide range of costs. There is no point in trying to go for a single figure at this stage, but I do not think we can, as Mr. Schoenberg suggests, ignore this altogether. Realistically, and politically, the Fund has to make a contribution and has to be seen to be making a contribution. I believe for us to say that we have reached agreement on continuing ESAF, but it is going to be a lot less than in the past, and, moreover, we are going from within this greatly reduced contribution to find some money for the debt initiative, will simply not carry conviction here or elsewhere.

On SCA-2, as for many others, its use would not be straightforward for us, but our view is that SCA-2 remains a potentially important element of the financing package. We clearly have some way to go in reaching conclusions. Mr. Wijnholds just said that it would be damaging to this institution to leave these issues unsettled for much longer. I look forward to hearing the Chairman's views, perhaps at the end of this meeting, as to how we should take this forward over the coming weeks and months.

Mr. Mirakhor observed that the cost estimates of the HIPC Initiative were subject to considerable uncertainty. The staff paper had noted that a 2 percentage point reduction in export growth in the HIPC countries could increase the Fund's share of the cost from US$5.6 billion to US$7.7 billion. In view of the sensitivity of the cost estimates to export growth assumptions, it could not be concluded that the Fund's share was manageable. He wondered whether Mr. Evans's assertion that the costs to the Fund were manageable was based on an assumption that the Fund should sell more gold than the 5 million ounces currently envisaged.

Mr. Evans replied that he was suggesting that the Fund sell up to 8 million ounces of gold, which would still be a modest share of the Fund's gold stock of 100 million ounces. He agreed that export growth assumptions were subject to uncertainty and export growth could be lower than estimated. However, debt relief would be provided on a case-by-case basis, based on actual export performance and not on estimates. On the whole, the costs to the Fund appeared to be manageable.

The Chairman remarked that if bilateral contributions were available, it might not even be necessary to sell the 5 million ounces of gold.

Mr. Evans reiterated that it was important to be realistic about the prospects for such contributions.

Mr. Shaalan, noting that Mr. Evans in his statement had said that the maximum debt relief from the Paris Club would be about net present value reduction of up to 80 percent, considered that it was important that the effective debt reduction by the Paris Club be 80 percent and not lower.

The Chairman remarked the debt reduction extended by the Paris Club, for example, under the Naples terms was guided by the conditions of that agreement. He would not wish for a false impression to be created that the Paris Club provided lower debt relief than the amount it committed. The HIPC Initiative would explain clearly the amount of debt relief that would be granted by the Paris Club and other creditors. He hoped that the Paris Club would provide net present value debt reduction of up to 90 percent.

Mr. Schoenberg said that he disagreed with Mr. Evans that the amount of financing through the ESAF in the future would be less than in the past, particularly if Zambia were to have an ESAF-supported program. Mr. Evan's proposal to sell even more than 5 million ounces of gold confirmed his suspicion that selling gold for the debt initiative would set a precedent for the future. Thus, when the next debt crisis appeared, there would be calls anew for selling the Fund's gold. That was the "Pandora's box" scenario that he had warned against.

The Chairman remarked that the proposal provided for "ring fencing" the investment income from the profits when they were no longer needed for the subsidy component of the interim ESAF. In those circumstances, it was difficult to see how a precedent could be set. The purpose of selling gold was to finance partially the new debt initiative, which, together with surveillance, was intended to remove the possibility that the membership would be faced with a debt crisis. Moreover, the Fund had sold gold in the past: the Structural Adjustment Facility had been financed from the proceeds of earlier gold sales. In that respect, a precedent had already been set.

Mr. Grilli commented that the uncertainty with respect to the projections meant that export growth could be higher than projected in some cases and lower in other cases. The overall estimates should be largely accurate. It was important to bear in mind that the debt initiative was aimed at giving countries a viable "exit" option from their heavily indebted state. It was difficult to define precisely how that would be achieved in each and every case. For instance, in some cases, a reduction in the net present value debt/export ratio to below 200 percent might be considered a sustainable situation, while in other cases, a threshold of 225 percent could be considered sustainable. He would note in that context that the total costs of the HIPC Initiative would be reduced by one-third if net present value debt/export ratios were reduced to 225 percent rather than 200 percent. Like Mr. Schoenberg, he was concerned that selling gold would set an undesirable precedent. Indeed, he was concerned that consideration of the sale of gold had already set a precedent, with some Directors calling for an increase in the amount of Fund gold that should be sold.

Mr. Shaalan considered that it was inappropriate to say that the Fund was selling gold; the Fund was merely changing the composition of its assets.

Ms. Lissakers made the following statement:

> I believe the staff's most recent papers on the ESAF and on HIPC have helped to clarify the implications of the various options under consideration. It

is certainly very helpful in our deliberations, even if having more ingredients in the pot does not necessarily make our task of reaching some final decisions any easier.

With regard to the financing of the ESAF, which cannot really be separated from the HIPC, it has been clear from the outset that the highest financial hurdle is finding the additional resources for the interest subsidy. The latest papers suggest that the subsidy cost of a fully funded ESAF, allowing levels of disbursements that I believe we all agree are necessary, and including providing for Fund participation in the HIPC Initiative, would amount to about SDR 2.5 billion, and that is on the basis of the rather optimistic assumptions in terms of the HIPC Initiative and the performance of the country in question.

We continue to believe that the primary responsibility for meeting this financing requirement will fall on the Fund through a more efficient use of currently available resources. With regard to HIPC specifically, bilateral donors are using their own resources to resolve the bilateral debt sustainability problem, which is correct, and we are certainly prepared and we recognize that the Paris Club countries are going to have to do more for a number of these most severely impaired cases. But we also insist that the international financial institutions must use their own resources to resolve the problem of unsustainable multilateral debt. The World Bank has come forward with a concrete proposal for a first-cut already as soon as next year, and that is very welcome. It is time for the Fund to put on the table its specific contribution to this effort.

As a practical matter, this will entail mobilization of a portion of the Fund's gold through investment of the profits on sales, use of the income to finance ESAF interest subsidies, and retaining the proceeds to strengthen the Fund's financial position. We do not agree that such gold sales would be inconsistent with the monetary character of the institution. As the Chairman has said himself, we see no conflict. And particularly if the resources are ring-fenced in the Fund when no longer required for ESAF purposes.

I must say that I am puzzled by Mr. Schoenberg's proposal which also includes the use of gold. We should be very clear on that. Mr. Schoenberg expresses great concern about the dilution of the Fund's reserve position through the investment of some portion of the gold in risk-free financial interest-earning assets which is what we are suggesting. Yet, he almost causally proposes to put directly at risk 15 million or more ounces of the Fund's gold through the very large gold pledge that would be required to secure financing ESAF through bilateral contributions for both principal and perhaps partly for the subsidy account. Now, I think we have to be very clear. So the choice is really not between gold or not gold, but between investing some of the gold in a risk-free asset, or putting a much larger amount of gold directly at risk. Our choice is very clear.

On the question of bilateral contributions, it is obvious that we do not object to others making contributions. Indeed, it is very welcome. But, as we have indicated previously, the United States is not in a position to seek congressional authority or appropriations for bilateral contributions to finance the subsidy account. We have suggested other ways in which countries can contribute to a continuation of the ESAF, including deferring refunds of the SCA-2 which, in our case, are quite large to strengthen the Fund's precautionary balances and to take account of increased risk that might result to the Fund, particularly if we are to use the GRA for some part or all of the extended ESAF.

Proposals to "stretch" current ESAF resources and tap the reserve at an early date strike us as decidedly second-best approaches. They would leave the ESAF seriously underfunded to meet its responsibilities, or require bilateral subsidy contributions that exceed even the ambitious goals in the Managing Director's proposal. Were we to proceed down this path, we would have to give serious consideration to using the General Resources Account for loan principal beyond the interim period, and also sunsetting ESAF operations in order to leverage the available resources as much as possible. Consequently, we think it is premature to take extended General Resources Account use and sunsetting off the table until we have clarified the resource modalities that we are going to settle on.

With regard to the HIPC Initiative, it seemed from the staff's comments yesterday that the fact that a number of chairs in the World Bank discussion did not repeat their disagreements with certain aspects of the staff's proposed framework for HIPC meant consent. Just to be clear on where this chair stands, we will repeat the concerns we have. We do not favor an approach that presumes increased relief by the Paris Club as a first step with the multilaterals remaining as a residual, as Mr. Evans and Mr. Mesaki said. There should be a coordinated and parallel effort by the creditors.

With regard to eligibility, we agree with Mr. Evans that this should be decided on a case-by-case basis based on a careful and detailed debt sustainability analysis following the current London Club and Paris Club models, rather than having an advance prescribed list of countries that will be deemed from the beginning to be eligible or not eligible. Decisions on the amounts of relief to be provided by various creditors, the Paris Club and the international financial institutions in particular should be made at the same time and at the decision point, so that there is certainty at the end of the performance period. We think the three-plus-three formula is too rigid, as Mr. Evans also said; we need to judge the specific case we are dealing with and what makes sense and what will have the most beneficial economic impact for the country in question. The Mozambique example is a very good one, the notion that, if a country wanders off the program for some short period, we absolutely have to turn the clock back to zero, does not make much sense.

With regard to the standards with benchmarks, we welcome the use of the lower bound of the net present value of debt/export ratios as one analytical tool to ascertain the debt relief needed. We agree that we need flexibility, and one needs to look at a variety of indicators, as Mr. Grilli said, and that is one of the reasons why I think it is hard to agree on an absolute firm list of countries.

It has been very useful to have an indicative list. I would ask—just to give us some idea of what we are grappling with—that we have the flexibility to make good judgments when we get to the specific cases. If we err on one side, it should be below the benchmarks rather than above. As I said before, some of the export growth assumptions may be optimistic.

The most recent joint Fund/Bank paper provides more detailed estimates of the potential costs, and these differ considerably from the earlier papers. We would appreciate some further explanation of the impact of HIPC on the level of ESAF lending. Our impression is that the staff has adjusted the level of lending during the period of self-sustained ESAF operations to take account of lower ESAF demand by HIPC-eligible countries. However, a similar netting does not appear to have been done for the interim period. Any resources for ESAF lending that are not used during the interim period would, of course, be available to increase lending in the self-sustaining ESAF. Moreover, we understand that the lower cost in the joint paper reflects shifting the base date from 2000 to 1996 to take account of more precise estimates of decision points and completion dates. However, the calculations do not take account of the effects of actions by the international financial institutions prior to the completion dates. An estimate of the effects of earlier action by international financial institutions would be useful.

Finally, with regard to the modalities for Fund participation in this initiative, each of the options proposed by the staff could be structured to achieve the same amount of debt relief in net present value terms. We would agree with the staff that extension of new loans as current obligations fall due would not provide the degree of assurance necessary to meet HIPC requirements, and, more important, it does not resolve the debt overhang problem. The other options involve a trade-off between the cost to ESAF operations and the debt profile of the borrower, although each could be restructured to be equivalent. On balance, we tend to lean toward the escrowed loan preferred by the staff, but one can see some obvious benefits to the escrowed grant approach, as well. I think we should defer a final decision until the resource situation confronting ESAF is clarified.

Finally, let me just say on HIPC that, as we grapple with these technical difficulties and the trade-offs between ESAF and HIPC, we may lose sight of the basic problem. The reality is that we have a group of countries whose debts are not sustainable. They cannot pay them. We have a choice of doing something to solve that, or continuing what I consider "Ponzi finance," in some cases, through one ESAF after another. The fact is that this debt overhang is overwhelming in these cases; if we do not lift the debt burden, the benefits of the sound economic policies that we are trying to encourage with ESAF will, at a minimum, be kept from reaching the majority in those countries. Countries may improve their external accounts, but they will not be able to benefit directly from improved economic performance if we do not lift this debt burden. I believe that we should not lose sight of that reality.

Mr. Schoenberg remarked that his proposal provided for 100 percent security for ESAF loans because the legal requirements in some ESAF lender countries required 100 percent security for their loans. However, his authorities were prepared to have less than 100 percent security. In view of the good track record of borrowing countries, it was unlikely that the gold pledge would be invoked.

Ms. Lissakers remarked that a larger gold pledge, however, carried considerable risk that larger amounts of gold would be sold. ESAF lenders would not ask for a gold pledge if they considered ESAF loans to be risk-free.

The Chairman noted that Ms. Lissakers had indicated the mechanism through which her authorities could make available their share of SCA-2 resources. They had suggested a merger of SCA-1 and SCA-2 resources for that purpose, with the merged resources being held in the GRA. Other members, however, had indicated that they preferred to make available their share of SCA-2 resources after those had been refunded to them. He considered that it should be possible to do both, namely, to merge the U.S. share of SCA-2 with SCA-1, as well as refund SCA-2 resources to other SCA-2 contributors. From a legal perspective, a full merger of SCA-1 and SCA-2 resources would require a unanimous decision on the part of the SCA-2 contributors, while an early refund decision would require a 70 percent majority in the Executive Board; those members wishing to merge their refunds with SCA-1 resources were free to do so.

Mr. Kiekens made the following statement:

> Our chair's support for the continuation of the ESAF is well known. I believe that the staff's work is very useful in helping the Board to deliver on the mandate it received from the Interim Committee to formulate, before the next Annual Meetings, precise proposals concerning the financing of ESAF. My preference for financing ESAF is Option 1. Let me address some additional aspects of the modalities of financing the continuation of ESAF, before turning to the HIPC Initiative.
>
> Belgium agrees with the Managing Director's proposal to finance half of the subsidy requirement with income generated by investing the profits of gold to be sold by the Fund, but only with appropriate safeguards to ensure that gold sales do not become a routine panacea for solving all kinds of financial problems. The Chairman of the Interim Committee, Mr. Philippe Maystadt, feels that such safeguards could help some countries that still oppose the idea of gold sales to overcome their reluctance, and I would encourage the staff to examine what safeguards might be devised for this purpose. I must admit that as long as major industrial countries continue to refuse to participate with bilateral contributions, their assurances that the proposed limited gold sales will not open to so-called Pandora's box are not especially credible. On the other hand, countries that fear such an outcome should have more self-confidence, since 15 percent of the voting power can block additional gold sales at any time.
>
> Belgium can also accept the use of SCA-2 resources to finance the other half of the subsidy requirement. Under this scheme, SCA-2 resources would be refunded to member countries with the understanding that those

countries will retransfer an equivalent amount to the subsidy account of the ESAF Trust, either as a budgetary grant or an interest-free loan as the country prefers. Belgium's contribution would take the form of an interest-free loan. My country would also be willing to supplement this retransfer of its SCA-2 resources with an additional bilateral contribution, provided there is appropriate burdensharing with other donors, particularly the major industrial countries.

Most of the countries of my constituency have not yet fully formulated their positions. It is my understanding that Austria's position is close to the German position set forth by Mr. Schoenberg in his written statement. Others have indicated that they could consider responding positively to the Managing Director's request, provided that their bilateral contribution is part of a broad-based effort by the major member countries of the Fund.

Turning now to the HIPC Initiative, there are many factors, enumerated on page 1 of the staff's background paper, which will affect the cost of this initiative. Some of the most important variables, such as the number of countries expected to benefit from the initiative, and the method of sharing the burden among creditors, are not yet clear. Hence the staff is right to stress that these calculations are to be regarded only as very approximate indications of magnitude. But although the exercise cannot give us more than a very general idea of the HIPC Initiative's possible cost, it very usefully illustrates the effects of the numerous variables.

These include burden sharing. The staff's technical note gives scenarios for the burden sharing of the initiative among all participating creditors. I was struck by the fact that one of the most important variables affecting the Fund's cost will be the level of debt relief to be provided by the Paris Club. Without adequate participation by bilateral creditors, the initiative would not only place too heavy a burden on the multilateral financial institutions, but would also threaten their preferred creditor status. The Belgian Minster of Finance, too, has some questions about the proposed burden sharing, but does not challenge the Fund's preferred creditor status. I think it is important for the Fund and the World Bank to commence more detailed discussions with the Paris Club creditors. Much will be clarified by looking at the effective debt reduction under current Naples terms, as applied under the Paris Club rules, and what it actually means to speak of increasing the rate of reduction from 67 percent to 90 percent. I consider the 90 percent proposal a good starting point for discussions.

The HIPC exercise also usefully demonstrates that the initiative's cost should be taken into account when assessing the resources needed for the continuation of ESAF. The Fund's expected share of the HIPC Initiative—about US$500 million valued at end 1996—should fit within the framework of the ESAF continuation as presently conceived. The staff presents four ways present for the Fund to contribute to the HIPC Initiative. I think preference should be given to whatever options have the least detrimental effects on the self-sustained ESAF. I also see some merit in smoothing out the

HIPCs' debt service obligations in connection with their repayments to the Fund. My preliminary position is therefore to agree with the staff's preference for the escrowed loan method, although, like Mr. Wijnholds, I admit that the escrowed grant technique is more transparent and limits the period of the Fund's involvement. However, the latter is less advantageous for the profile of the country's external liquidity position. I understand that each of the proposed techniques requires an amendment of the rules governing ESAF operations, or even a new legal instrument. Indeed, the loans to be provided in order to reduce the net present value of the outstanding debts to the Fund differ in nature from the present ESAF loans, will be financed with specific resources, i.e. those available in the Special Disbursement Account, and will be governed by an entirely different set of rules and conditions.

Mr. Kannan made the following statement:

The views of this chair on this issue are well known. I can therefore be brief.

This chair supports the efforts to put ESAF on a more permanent basis. We also recognize that there are differences of opinion in the Board on various elements that make up the proposal. The series of meetings that we had so far has helped to identify the differences more clearly, and also to narrow down the differences to some extent. I would like to compliment the Managing Director and the staff on the meticulous manner in which they have tried to build upon the suggestions that have emerged at each meeting and come up with fresh compromise proposals. While this chair will endeavor to support the final consensus that may emerge on the matter, I am duty-bound to point out that with each compromise, the contents and quality of the interim ESAF keeps going down. If this process is continued, then we may end up with a final outcome that may not be commensurate with the efforts put in.

We have already indicated our support for the sale of a limited quantity of gold and the profits from the investment of the proceeds from such sales being utilized for the funding of the interim ESAF requirements. We also have supported the use of Fund reserves for this purpose. Our only desire has been that the interim ESAF should be sufficiently large enough to meet the projected requirements, and also that its duration must be sufficiently long enough to move the scheme away from the present sudden death syndrome.

On the question of bilateral support, you have returned to seeking voluntary contribution. The Director of the Policy Development and Review Department, in his briefing to the staff, has also urged it to follow up this matter with the authorities during Article IV and program discussions. While we welcome the efforts for broadening the base of bilateral contributors for the interim ESAF, we have supported such efforts, even in the present ESAF, with two of our countries in our constituency making contributions. This chair would like to point out that the contribution from the developing and program countries can at best be only a token, a gesture with the bulk of the bilateral contributions coming from the traditional industrial donor countries. In this forum it has been repeatedly stated by many industrial countries that their countries' contributions might be constrained by the need for fiscal consolidation. I would like to point out that this problem is dealt with to an even larger extent in the developing and program countries, which, while having to put through perhaps a stronger fiscal consolidation process, are also required to take steps to augment the flow of resources to crucial infrastructure sectors as well as human resource development. This aspect should not be lost sight of while seeking the broad-based bilateral contributions. It is also for this reason that this chair has been urging that SCA-2 surpluses should be refunded to the contributors, leaving it to the countries to decide on what quantum of funds they should place back with the Fund for financing the interim ESAF. I would like to reiterate that point.

Mr. Dlamini made the following statement:

I share most of your views and concerns contained in your statement for today's discussion. I strongly favor providing continuity of ESAF operations indefinitely on a self-sustained basis. I also strongly consider that the Fund should aim at a level of support that is sufficient to credibly position it to respond effectively to the needs of all the ESAF-eligible countries. In that regard, it is this chair's view that from among the options set out in the staff paper, Option 1 or Option 1(a) appears to be a preferable alternative because either option would facilitate the continuation of ESAF operations on a level of financing that is relatively close to the projected likely demand for ESAF resources.

Another aspect that makes either of these options more attractive is the absence of recourse to Special Disbursement Account resources, unlike the other options including the sunsetting options with a solitary impact on the Fund's lending capacity under the self-sustained ESAF. This aspect of nonreliance on special disbursement account resources on Option 1 or Option 1(a) has also an additional advantage in that it helps to minimize the impact of the Fund's participation in the HIPC Initiative through the use of SDA resources on regular ESAF operations. In this connection, I am pleased to note the positive view expressed in the Managing Director's statement regarding this option. Therefore, to ensure a reasonable level of ESAF operations during the period 2000–04 and beyond, and to keep to a minimum the possible sale of gold, a significant amount of bilateral subsidy contributions will be necessary. Heavy reliance on bilateral support for subsidy becomes all the more important if the Fund were to adopt any one of the other options that apparently involve the use of Special Disbursement Account resources. This is because, as noted in the staff paper, the share of subsidies financed through the use of the SDA has a critical impact on the level of self-sustained ESAF operations. The lower the share of Special Disbursement Account resources used, the larger will be the Fund's lending capacity under the self-sustained ESAF. This is also true in the case of the Fund's participating in the HIPC Initiative, as indicated in the relevant tables in the staff paper.

Having said this, let me comment on some of the specific issues raised in the staff paper.

To start with, in my view, reliance on new bilateral loans is worth considering. In this regard, our preference is for these loans to be used as envisaged under Option 1 and not under Option 2, as the latter involves use of SDA resources for subsidy with adverse consequences for the capacity of the self-sustained ESAF. As regards the level of reserve coverage and required gold pledge to protect the claims of bilateral creditors on the ESAF Trust, perhaps full substitution for the reduced protection as a result of the early transfer of resources from the Reserve Account to finance ESAF operations may not be necessary. This is because the experience under both the Structural Adjustment Facility (SAF) and ESAF shows that the record of payments has been strong. Moreover, the main protection for the creditors lies in the strength and quality of adjustment programs which the Fund always strives to ensure. The bilateral creditors' exposure to risk could also be contained as regular staff reviews of policies of the individual countries help to identify early the emerging problems that could lead to delays in payments or default.

On GRA sunsetting, I do not have to say much except to indicate that because of the several disadvantages associated with it, including those that make it impossible for the operations to continue indefinitely, every effort has to be made to put in place either Option 1 or Option 1(a).

In the context of the Fund's participation in the HIPC Initiative, I note that, as already indicated above, Option 1 exerted a minimum impact on the level of resources for financing the self-sustained ESAF. Among the other options, the sunsetting option has the added disadvantage of shortening the period of ESAF operations. In the circumstances, it would be necessary to opt for option (a) as far as possible. As the resources to be available under the self-sustained ESAF appear to be on the low side, it would be beneficial if recourse is avoided to SDA resources to limit the costs associated with the HIPC Initiative. This would require reliance on other sources of financing. Perhaps one of the options could be the use of a portion of income on the invested profits from the sale of gold. This could be possible if the share of bilateral contributions can be significantly increased over and above the level envisaged in Option 1. If there is a difficulty in achieving that, it may not be unbecoming of the Fund to opt for a sale of an additional modest amount of gold.

As regards the financing modalities that should be pursued, I share the staff's view that preference be given to the escrowed loan approach in view of the less adverse implications it has for the debt-service profile of the borrowing country compared with the other financing modalities.

In concluding my comments, I am tempted to voice my concern as I did on previous occasions regarding the level of commitments during the years 2000–04, and beyond. Even under Option 1, the level of resources to be committed is far below that was witnessed in recent years. Although it is hoped that some countries may in the future graduate from the use of ESAF resources, pragmatism will require us to assume that the demand for ESAF resources will not diminish as reflected in the staff projections in order to aim for a much higher level of financing that could also help to minimize the impact of the Fund's participation in the HIPC Initiative on the level of self-sustained ESAF. It is also my strong view that a credible ESAF scheme should be able to meet the needs of all eligible members. For that to happen, it would be necessary to include the three protracted arrears cases which have been left out in the projections. If it is necessary to maintain the separate presentation of financing requirements of nonarrears cases, then it would be equally essential that an additional presentation, which also takes account of the arrears cases, be provided.

Mr. Zhang made the following statement:

I welcome this opportunity for the Board to further discuss the ESAF financing modalities. I also wish to commend the staff for the informative and detailed papers they have prepared for us. As we have reiterated on previous occasions, my authorities have strongly supported continuation of the ESAF and the important role played by the ESAF in assisting economic adjustment programs in the developing countries. We also see that a constructive contribution could be made by the Fund, through ESAF operations, toward the alleviation of debt burdens on the heavily indebted poor countries. I would like to take this opportunity to express appreciation on behalf of my authorities for the efforts made by management in securing financing resources for the continuation of the ESAF.

Generally speaking, we are in favor of the financing option that will join Fund resources with bilateral contributions to support the continuation of ESAF operations for an interim period while leaving the full capacity of a self-sustained ESAF to be built with the Reserve Account. Specifically, I think the modified Option 1 offers a linear approach, taking into account its additional advantages of a lower level of gold reserves mobilized by the Fund and a higher degree of protection maintained for the current ESAF Trust obligation.

On the sale of gold and pledge issues, we agree with the suggestion for the sale of a modest amount of Fund gold reserves to finance half of the interim ESAF interest subsidies. And we can also endorse the proposal for the additional amount of 5 million ounces of gold to be pledged for covering the arrangement under the Fund HIPC Initiative.

While I tend to agree with the staff on the technical assumptions in their preliminary cost estimates of the Fund's participation in the HIPC Initiative, I would like to support the view calling for more efforts to be made to secure additional financing resources in light of the possibility that larger demand may arise from unfavorable economic developments in some member countries. This possibility is highlighted by the list of uncertainties contained in the staff papers. In reference to the modalities for the HIPC Initiative, however, I find myself attracted to the idea of extending escrowed loans to eligible countries from SDA resources as a preferable option. Regarding HIPC strategy, since the World Bank and the Fund together play an important and central role, I would like to see closer collaboration between the two organizations.

Regarding the bilateral support to ESAF operations, as my colleagues may be aware, my authorities have made their best efforts to support Fund ESAF operations since the establishment of the ESAF in 1987. China, as an ESAF-eligible developing member, decided to forgo the privilege of accessing the concessional loans so that more funds would be available for arrangements with other members in need under the first ESAF. Furthermore, as part of our active support for the enlargement of the ESAF program, China has pledged to contribute SDR 100 million to the Loan Account and a grant contribution of SDR 12 million in the period since July 5, 1994.

Finally, concerning support for the financing of ESAF interest subsidies, while meeting the same difficulties faced by other countries, we will make a contribution according to our economic capacity. And I can assure you that my authorities will give full and positive consideration to any suggestions constructive to the continuation of the ESAF.

Mr. Grilli made the following statement:

On the ESAF-financing options, I believe that we are traveling a little too enthusiastically or perhaps a little too deterministically the road of a gold sale. Our view remains that to find a reasonable and globally acceptable solution to the question of how to finance the interim ESAF we have to look at other alternatives, more in the neighborhood of Option 2 than of Option 1, and exploit all the flexibility that we can find in such a neighborhood. I also believe that we should look realistically at sunsetting options, and not in a mechanical way. Option 2, in essence looks at the possibility of using existing Fund resources to the maximum extent, for both ESAF loans and subsidies, and to add to them bilateral contributions from member countries. I find no valid reason, except for burden-sharing, intended in a literal sense, to believe that the latter would be forthcoming only in the presence of a sale of gold. I know that in our case, quite the opposite is true.

It is for this reason that I found the ideas put forward in Mr. Schoenberg's note useful, realistic and attractive: useful because they focus on the need to tailor "demand" to the "supply" of concessional resources; realistic because they exploit the room that exists to shape a solution to the financing problem; and attractive because they attempt to bypass the contentious issue of gold sales on which we cannot find agreement. I also believe that ways of increasing the comfort of ESAF bilateral creditors can be found by pledging appropriate amounts of gold to this purpose. Gold pledges, I believe, can be easier to accept than gold sales by the membership at large. I also believe that additional elements of flexibility could be built into any such scheme. Fund members, for example, who are currently not in position to retransfer SCA-2 resources to the Fund as bilateral contributions for ESAF subsidies could consider merging their shares of SCA-2 into the SCA-1, so as to strengthen the Fund's liquidity. This may facilitate the temporary use of GRA resources, should bilateral contributions not be timely enough to cover loan requirements or were we to face at some point unforeseen demands. Sunsetting could be considered, should a non-temporary use of GRA resources for loans become strictly necessary, to limit its amount and the problems connected with the use of GRA resources for long-term development-type assistance to members.

For our part, while remaining opposed to the sale of gold, we are ready to explore financing options involving: (a) the financing of ESAF loans with bilateral credits and some use of GRA resources; (b) the financing of ESAF subsidies with the use of SCA-2 resources and bilateral contributions; (c) the use of gold pledges as needed. This is a clear demonstration of our flexibility and willingness to help finance ESAF in ways that will not touch, at a fairly critical juncture, the main reserve assets of the Fund and open Pandora's box–type problems down the road. We are flexible and forthcoming because, like the Managing Director, we believe that ESAF resources can unlock, in the right circumstances, a sizable policy multiplier. But, we really believe that if an agreement cannot be found within these boundaries, it will not be for our lack of trying or our lack of adaptability to the realities of the present situation. We want to find a solution and are willing to continue to work for it.

On the cost for the Fund of participating to the HIPC Initiative, I believe that the estimates made by the staff are highly tentative and thus notional. This is to a large extent inevitable. Export growth projections over long time periods are inherently subject to wide margins of error, debt-export thresholds are by necessity arbitrary, non-debt creating capital inflows are in part endogenous and in part exogenous and thus difficult to forecast. What I found disappointing in the joint paper is not this aspect of the cost estimates, but the implicit open-endedness of the list of countries considered as possible candidates for debt reduction. The paper still includes the so-called "possibly stressed" countries, together with those whose debt is considered "unsustainable," and then differentiates between those for which "no costs are accounted for in the costings, but for which further action may be required" and countries for "which associated costs are accounted for in the costings." This is highly ambiguous language, reflecting ambiguous concepts. At a minimum it creates expectations, and perhaps even a sense of entitlement, in countries that should not consider themselves entitled to a highly preferential debt treatment from multilateral organizations, at the maximum it fosters moral hazard. I am also afraid that handled in this fashion, the list of possible eligible countries will make it more difficult, if not impossible, to keep the debt initiative within reasonably certain (or just reasonably uncertain) terms, and thus make it more difficult to accommodate. The cost of the initiative should have been based—and should be, in our opinion—on the list of countries with "unsustainable debt burden," with an added contingency for countries that within the time the debt reduction option will be available will be found as meeting the same conditions. Case-by-case choice should remain limited to those countries whose debt is no judged to be unsustainable. This would be not only realistic and minimize, but would also minimize the moral hazard problem and render the estimates less uncertain and more acceptable. I am afraid that, given the basis on which the cost estimates were worked out in the joint paper, the only logical position becomes that of Mr. Schoenberg, i.e., that no given amount can be set aside for the HIPC Initiative. I would have clearly preferred that we had one such amount set aside.

On the possible modalities of a Fund participation in the HIPC debt initiative, our preliminary views are as follows: (1) escrow loans and escrow grants seem to provide the best options and both should be considered at this stage; (2) we believe that flexibility needs to be maintained in the time frame of adjustment, but against a strict background of policy action by beneficiaries and a time scale sufficient to reduce the gap between the current and a sustainable debt burden and we favor, therefore, the 3 plus 3 framework envisaged in the paper; (3) we may not be very wise in assuming that our role is always residual with respect to debt reduction of bilateral creditors, as the Managing Director indicated, and we should try to be flexible—with the preferred creditor status of the Fund; (4) a 80 or 90 percent debt reduction by the Paris Club many not necessarily be the standard point of departure and, at the same time, we believe that the multilaterals' main role is that of helping countries achieve consistent results in reducing their external debt burdens through good policies, and the right amount of debt forgiveness; and (5) finally, we strongly support the notion that this debt reduction option should be close-ended.

Mr. Mirakhor asked Mr. Grilli to elaborate on his remark that the Fund should set aside a specific amount toward the debt initiative, and whether he was suggesting that that should be done before or after commitments had been made by the Paris Club.

Mr. Grilli responded that the uncertainty regarding export growth projections notwithstanding, the Fund should estimate costs based on certain reasonable assumptions. It was important therefore to hear from Paris Club creditors the amounts of net present value debt reduction they would be willing to undertake, and to estimate the cost to the Fund accordingly. In estimating the cost, the assumption should be that only a fixed group of countries would be eligible for debt relief under the debt initiative.

Ms. Lissakers remarked that under the staff's proposal the Paris Club would be making a commitment at the "decision point" and the multilateral institutions would make their commitments later. Both the Paris Club and the multilateral institutions should act simultaneously and make commitments at the "decision point" so that a country entering into an adjustment program would know right from the start the amount of debt relief it would receive at the end.

The Director of the Policy Development and Review Department noted that, under the staff's proposal, when a country reached the so-called "decision point," a revised debt sustainability analysis would be undertaken. On that basis, all the creditors—the Paris Club, other bilateral creditors, commercial creditors, and the multilateral institutions—would decide on the amount of debt relief the country would be eligible for in order to attain a sustainable debt burden at the "completion point." At the "decision point" creditors would also make specific commitments of their share of the debt relief. The only difference was with regard to the timing of the disbursements. Thus, at the "decision point," Paris Club creditors would provide for a net present value 90 percent flow debt reduction, and, at the "completion point," they would provide a 90 percent stock-of-debt reduction. The Bank had raised the possibility of providing IDA grants during the second stage, and there was also the possibility for the Fund to provide exceptional relief at that stage.

Ms. Lissakers remarked that the multilateral institutions should be providing relief during the second stage as well.

Mr. Mirakhor asked the staff to clarify whether a country would be receiving debt relief from the multilateral institutions during the two stages of the adjustment process.

The Director noted that, under the proposal, the country would be receiving Fund support for an adjustment program in the first stage and would also be eligible for exceptional, additional relief during the second stage.

Mr. Evans asked the staff to explain the nature of the Fund's contribution to the HIPCs prior to the "completion point," particularly whether the Fund would act in concert with bilateral and commercial creditors or whether it would contribute only after other creditors had contributed their shares.

The Director of the Policy Development and Review Department stated that it was important to distinguish between commitment and action. At the "decision point," all creditors would make a commitment to provide debt relief in a manner that would make a country's debt burden sustainable. The commitments would be based on creditors' exposure to the country in question. For example, if a country was indebted only to the Fund and the Bank—with both institutions' claims being equal—the net present value reduction by the Fund would equal the contributions by the Bank. On the part of the Fund, the country in question would have an ESAF-supported program during the second stage, and, at the "decision point," the Fund would make a commitment to provide relief through the escrowed loan or grant, so that at the "completion point" the country's net present value debt/export ratio was at or below the 200 percent level, assuming that it was agreed that the net present value of the country's debt/export ratio was to be reduced to 200 percent. An earlier paper had suggested that, in the event that a country's situation at the completion point differed from that envisaged at the "decision point," the Boards of the two institutions would reassess the debt sustainability of that country. However, that would only be in exceptional circumstances in those cases in which a country had experienced windfall gains. The country would not be "penalized" for performing above expectations. Thus, under the proposed HIPC Initiative, the commitment by all creditors would be made simultaneously at the "decision point." The only difference was that debt relief would be provided by the bilateral and commercial creditors prior to action by multilateral institutions.

Mr. Mirakhor asked whether there would be two decisions: one, a joint decision by all creditors on the total amount of debt relief to be provided, and, two, a decision by them on the amounts provided in individual cases.

The Director replied that all decisions would be on a case-by-case basis. It would not be possible to set aside ex ante a specific amount that the Fund would be contributing. The staff had done the debt-sustainability analysis based on the assumption that about 20 countries would be eligible for debt relief and had tried to estimate the cost to the Fund of providing relief to those countries. The assumption was that the Paris Club would be providing up to net present value 90 percent debt relief on debt flows and on the stock of debt. On that basis, the total cost would be about US$5.6 billion in net present value terms and the Fund's share would be about SDR 0.55 billion.

Mr. Evans observed that, while the Paris Club would be providing debt relief during the second stage, the Fund would not be making its contribution until the "completion point." He considered that there should be equitable burden sharing between the bilateral and multilateral creditors and that the Fund should be providing debt relief during the second stage.

The Director of the Policy Development and Review Department considered that, as the Fund would be making its commitment at the "decision point" it made little difference whether the actual relief was provided during the second stage or at the "completion point." In both cases, the amount of relief provided would be the same.

Mr. Evans considered that, from the perspective of the country concerned, it made a difference whether the Fund provided debt relief during the second stage or after it.

Mr. Berrizbeitia considered that the approach proposed by the staff was consistent with the catalytic role of the institution, which should be maintained. He agreed with the staff that it made little difference when the relief was provided, but considered that, given the preferred creditor status of the institution, Fund participation would be more appropriate after the second stage.

Mr. Saito made the following statement:

> Management and the staff should be commended for their ongoing efforts to find a workable compromise on the fully financed interim ESAF in the context of the proposed initiative to assist the HIPCs in eliminating a major obstacle to their economic recovery, which is an excessive external debt burden. As in the past, this chair remains committed to the continuation of the ESAF as the centerpiece of the Fund's strategy for supporting macroeconomic stabilization and structural reforms in low-income countries. In reaffirming this position, we also wish to underscore the urgency of ensuring that all countries with unsustainable debt positions and committed to adjustment and reform be eligible for the HIPC Initiative.
>
> For the reasons expressed by the Managing Director in his statement and the staff's helpful papers, this chair endorses a balanced modified Option 1 in the understanding that it constitutes the best solution. Let me briefly outline our reasons for subscribing it.
>
> First, it provides coverage of the projected demand of SDR 1 billion per annum, and ensures a credible level of ESAF operations up to, and including the interim period 2000–04. Beyond that point, remaining excess resources would be available to finance a self-sustained ESAF, as called for by the Interim Committee. This means ensuring a continuation of ESAF operations in a balanced manner without resorting to GRA sunsetting. We cannot realistically expect, that the deep seeded problems of most HIPCs will be resolved quickly. Exhausting SDA resources prematurely by sunsetting may lead to much higher costs later on.

Second, considering that budgetary constraints are a fact of life, as acknowledged by the Managing Director, financing half of the subsidy component through gold sales, and the other half from bilateral contributions, still constitutes the most reasonable and straightforward option. Thus, we continue to support the sale of a modest amount of the Fund's gold and the use of the income from the investment of the profits from such sale to assist the poorest member countries. A cautious and prudent disposition of a modest amount of gold would not weaken the Fund's financial position, and could significantly strengthen it if supplemented by bilateral contributions to advance adjustment and reform efforts under Fund-supported programs. Moreover, should GRA resources be used to finance the loan component of ESAF operations then the merger of part of SCA-2 with SCA-1 for purposes of strengthening the Fund's precautionary balances should remain as a practical option. Regarding other direct bilateral contributions, my Paraguayan authorities have already expressed to the Managing Director their willingness to participate.

On the HIPCs debt initiative, we agree that the contributions should be made through a reduction in the net present value of the Fund's claims on eligible countries. This relief should be provided through the use of the SDA resources on a one-time basis. The extent of the necessary debt reduction should be determined on a case-by-case basis.

Turning now to alternative modalities for implementing the HIPCs initiative, the "escrowed loan" represents a possible best solution for the group of countries identified as needing a reduction in multilateral debt. Nonetheless, the "escrow grant" proposal also has the advantage of simplicity and the smaller withdrawal from the SDA that would be required, suggesting that it should not be ruled out at this stage.

On the technical note on preliminary costing of the proposed framework, we share the staff's view that not only countries considered "unsustainable" should be included, but also those classified as "possibly stressed," given the difficulty of defining precisely a cutoff for sustainability and the sensitivity of the assumptions used in the analysis.

To conclude, we support a solution that resolves the problems of the HIPCs and minimizes the risk to the Fund's financial position. The fact remains that despite sustained efforts to implement sound macroeconomic policies and continued structural reforms, and that many countries have been granted debt relief under the Naples terms, their problems remain essentially unsolved. In this connection, a definite solution should be directed at achieving sustainability for all those HIPCs that have maintained a good track record and made significant efforts in the process of adjustment and reform.

Ms. Srejber made the following statement:

I will not give a long statement as our views are well known. In general, we attach importance to securing financing for a continued ESAF at an adequate level while preserving the monetary character of the Fund.

On issues for discussion, we have the following views:

We still believe that further consideration should be given to a further round of bilateral lending. Capital subscribers should in general be given full reserve coverage, but this issue will have to be settled within an overall framework for fair and broad burden sharing.

In order not to completely change the monetary character of the Fund, we do not accept general resources account sun setting.

We find it important that the heavily indebted poor country initiative be incorporated, and agree that an escrowed loan on extended maturities is the preferable financing modality. It has the least disadvantages. Furthermore, it is also the best alternative in terms of smoothing out debt service over time.

According to the document, a heavily indebted poor country is generally not expected to need other ESAF resources directly after completion of the second stage. It seems unrealistic that economic and financing problems will have been solved after six years or so.

We find that Option 2(a) is the most attractive. There is no change in the Nordic-Baltic position or views of individual countries as to the different elements of the options mentioned in the document. Furthermore, after incorporating the heavily indebted poor country initiative, we are also concerned about the implications in terms of the low annual commitment level in Option 4(a) which is an inherent weakness in this option. We find that Option 1 in the new German proposal deserves further deliberations. However, the proposal does not seem to accomplish a desired burden sharing. Furthermore, the heavily indebted poor country initiative must be incorporated into the proposal.

A number of previous speakers have commented upon the preliminary cost estimates of the Fund's participation in the proposed heavily indebted poor initiative, all echoing the fact that the costings of this proposed framework are, indeed, highly tentative, dependent on a number of unknowns and uncertainties, and therefore bound to change many times yet before final estimates can be presented.

In his statement, however, Mr. Schoenberg points to yet another kind of uncertainty we need to pay attention to in this exercise, and maybe attempt to recognize. I am referring to the reduction in the net present-value-debt-export ratio we are trying to achieve, and which, when it is now put at 200 percent, according to the staff in the technical paper, is just chosen for illustrative purposes only.

Finally, all countries in my constituency have given careful consideration to your letter, and while confirmation is still pending, I can report that some countries is, in a positive spirit, considering to contribute bilaterally, provided principles of fair and broad burden sharing would prevail. Bilateral contribution through the use of SCA-2 resources, however, pose legal problems.

Ms. Lissakers considered that Option 2(a) was less preferable than Option 1 because it entailed a gold pledge of 19.4 million ounces. Moreover, under that option ESAF lending after 2005 would be only SDR 660 million as opposed to the SDR 800 million under Option 1.

Ms. Srejber remarked that her authorities were willing to consider less than 100 percent security. Thus, the gold pledge could be of a lesser amount than required under Option 2 (a).

After adjourning at 1:00 p.m., the meeting reconvened at 2:35 p.m.

Mr. Waterman made the following statement:

I do not know whether it is appropriate for me to break the golden silence, but I thank the staff for its further work on ESAF and the HIPC Initiative. It is a very complex paper and analysis, but that reflects the number of variables that apply, and it seems to me that, if we want to make progress, we cannot vary the basic assumptions about the transitional arrangements, and the scale of the ongoing operations, and so on. So we are prepared to accept the figuring and assumptions provided by the staff as a basis for discussion and decision making.

I will go through the issues relatively quickly. We are prepared to support the use of GRA resources to fund the principal component of the interim ESAF, if that is helpful. Getting the required subsidy for the interim ESAF and HIPC Initiative of around SDR 2½ billion is a significant challenge. Like many other countries, we are also facing tight budgetary situations, and further bilateral contributions will be difficult. The most promising option for us is the possible use of SCA reserves, if they are refunded to the membership for redepositing with the Fund, but for some in this constituency, there are procedural and presentational challenges even with that option. One difficulty that I have is that I may not be able to provide a definitive answer for some time, but I certainly do not want to rule out this option. The timing of the transaction could also be important to us. We are prepared to see gold used as a pledge to access reserves at a somewhat earlier time, but accept that this has implications for the self-sustained ESAF.

On the use of the interest income from investment of profits generated by the sale of a small amount of the Fund's gold, views within this constituency are somewhat nuanced, but we would be prepared to go along with the proposal put forward by management if it helps in reaching an overall agreement.

On sunsetting, we accept that there are pros and cons associated with this option. We accept that ESAF, or something like it, will be needed for some years, but it would be a significant achievement to get agreement on the continuation of ESAF until, say, 2020 or 2025. The economic challenges facing member countries are likely to be very different by then. Whatever we agree to in the next few months will need to change as the years go by. So, while we see the costs, like the Managing Director and others, in terms of the implications of sunsetting for exhaustion of SDA, the extended use of GRA resources, and the need for higher precautionary balances, sunsetting would, nevertheless, make the arithmetic easier, and it could be a way of reaching agreement on the overall structure. So we see some attractions in that possibility and believe it should be kept on the table.

The analysis of the HIPC Initiative is very useful, but whatever we do needs to be integrated with what the Bank is proposing and what can be expected from other multilateral institutions and bilateral contributors. As Mr. Clark suggested in his statement, it would be quite useful to hear the preferences of the HIPCs on the various possible approaches and the impact they see on their debt service profiles. But, if focus is on achieving a more manageable debt service profile, the escrowed loan might be the preferable approach. That is where I would come out, at a personal level, on a first consideration of the issue. But the escrow grant also has some attractions, as others have noted today. It would be complex and, subject to what the staff says, it may be even unrealistic, but maybe a case by case approach would be the best way to go, as it could take account of the overall implications for individual countries of the bilateral and other multilateral initiatives, as well as the Fund's own assistance. If we went that way, it would help ensure that the country being assisted plays a central role in the agreed arrangements.

More generally, I support what Mr. Evans and Ms. Lissakers had to say about the degree of flexibility that we need and the way in which the Fund operates within the proposed HIPC framework. I also agree it is important that the Fund not be seen as lagging behind the other participants, including the World Bank.

Mr. Berrizbeitia made the following statement:

I favor Option 1 (as second-best) or Option 1(a) as the most feasible mechanism to achieve a self-sustained ESAF with an adequate level of commitments after 2004. Both options entail the sale of a modest amount of the Fund's gold holdings to finance part of the necessary subsidy component, which I support.

As regards the rest of the subsidy component itself, my authorities are in general well disposed to considering participating in the subsidy account, on a bilateral and voluntary basis, including through the possible use of resources in the SCA-2 account. However, any decision to participate would have to be adopted individually by each potential contributor in my constituency, and I am not currently in a position to formally commit any one of the member countries that I represent.

Participation in the subsidy account should be universal, in the sense that all members capable of contributing should participate, even if not necessarily all at once to accommodate specific individual situations. And it should be equitable, in the sense that burden sharing should substantially approximate the quota shares of member countries in the Fund, which this chair has repeatedly emphasized should serve as reference both for rights and responsibilities in the Fund. On the basis of these general criteria, I have recommended to my authorities a positive consideration of the Managing Director's request for bilateral contributions.

However, for the record, I wish to reiterate this chair's oft stated position that the sole use of SCA-2 resources does not allow an for an equitable distribution of the financial burden, either among creditor countries, or among debtor countries. This is the case because those countries that have participated more intensely in the operational budget over time, as well as those that have made more intensive use of the Fund's general resources, would bear a disproportionately large share of the financial cost of the subsidy component during the interim ESAF.

In case that the criteria of equity and universality cannot be met, or that resources made available for the bilateral element of the subsidy component are not sufficient, this chair would support the sale of a somewhat larger—but still modest—share of the Fund's gold holdings, which could facilitate the achievement of the necessary financing of the subsidy component to ensure the continuation of ESAF. Conversely, if bilateral contributions were to be greater than currently foreseeable, then the amount of gold to be sold could be reduced.

I must say that conceptually I agree with the principled position which has been expressed by Mr. Schoenberg and others, in that it would be preferable not to sell any of the Fund's gold except in the context of an optimal asset management strategy. However, I also agree with the position expressed by the Chairman, that the Fund and the international financial system are strengthened by the Fund's capability to continue to be "pro-active" in its relations with its poorer members, through extending and making the ESAF self-sustained and by participating actively in the HIPC Initiative. I also agree with Ms. Lissakers that use of the gold pledge entails a potentially greater risk for the gold holdings of the Fund, than the proposed use of the proceeds on the profits from the sale of gold for subsidy purposes.

Now, if fiscal and political realities do not allow for bilateral contributions to avoid the need to sell gold, then we must be prepared to be less strict in preserving one principle, that of no gold sales, in favor of another principle, that of continuing to strengthen the role of the Fund in the international financial system. Thus, I do not feel that, in supporting the sale of a modest amount of the Fund's gold, we are sacrificing any principle in the altar of pragmatism. Rather, we are accommodating two principles at the same time: protecting the Fund's capital base, while strengthening the role of this institution.

As regards the HIPC Initiative, I wish to support Ms. Lissakers's statement to the effect that eligibility must be considered on a case by case basis, and not on the sole basis of a rigid pre-established list; and that a variety of indicators will need to be taken into account in the context of the case by case approach. This is necessary because situations that make debt unsustainable may vary across heavily indebted poor countries, either now, or in the future. Thus, the broad framework that we agree upon should be sufficiently flexible to deal with the different types of unsustainable debt situations which may not all be entirely apparent on the basis of currently available information.

On the possible financing modalities for the HIPC Initiative, I support the views expressed by the staff in favor of the escrowed loans option, and—as an alternative option—the escrowed grants.

Mr. Schoenberg remarked that all the financing options assumed that ESAF borrowers would make their repayments in time. Thus, in terms of risk assessment, it mattered little which financing option was chosen However, if ESAF loans were financed through the GRA, the Fund would have to rely on GRA resources in the event that a country failed to meet its payments obligations. However, if ESAF loans were financed through bilateral contributions option, the Fund would invoke the gold pledge in the event of nonpayment by an ESAF recipient country. Thus, the risk for the Fund was the same. Indeed, in the former case, there might even be calls for additional gold sales.

Ms. Lissakers observed that if ESAF lending was done through the GRA, the Fund would rely on its precautionary balances if a country failed to meet its obligations and only as a last recourse, on gold sales. Under the bilateral lending option, the first recourse in the event of arrears would be gold sales.

Mr. Calderón made the following statement:

This chair supports not only a self-sustaining ESAF but, equally important, an ESAF with the capacity to maintain annual commitment rates similar to current levels. The only two options in the staff document which satisfy these conditions are 1 and 1(a).

In our previous statement we argued that the best way to meet ESAF resource requirements would be with the use of GRA resources. Although we understand that we would be extending the period of use of such resources, the principal of the temporary use of such financing would still be preserved.

Regarding the subsidy requirements, we still believe that the best way to meet these is through a combination of gold sales and bilateral contributions. For the latter, we would be prepared to consider the use of SCA-2 resources.

Nevertheless, we are open to other options, provided, as we mentioned before, that the sustainability and resource level of ESAF is guaranteed. One possibility could be a modality in which the interim period 2000–04 is financed with GRA resources; half of the subsidy requirements would come from

SCA-2 reserves and the rest from direct bilateral contributions. Finally, a moderately high credit protection would come from a gold pledge.

With respect to the HIPC Initiative, it is clear that a self-sustained ESAF is the mechanism by which the Fund will participate in such a scheme. The issue of how to make this contribution is presently less critical, and could be postponed until we have a better idea of the costs of the Fund's participation in the HIPC Initiative. In the meantime, we could go along with Mr. Schoenberg's suggestion of using the annual availability of ESAF resources in a flexible manner. Eventually, we would be inclined to the escrowed grant modality because, as Mr. Clark assents, this modality would provide the simplest facility, is more transparent, and requires the smallest withdrawal from the SDA.

Mr. Al-Tuwaijri made the following statement:

At the outset, I would like to compliment the staff on the clear set of papers. I also welcome the Managing Director's continuing efforts to help reach a timely conclusion of our discussions on ESAF.

I can broadly endorse the Managing Director's proposed approach and will make only three brief remarks.

First, regarding the proposed options, my preference would be for the modified Option 1. While Option 1 (a) is attractive as it would not entail the use of GRA resources, the magnitude of the gold pledge that may be required is very large. With respect to bilateral contributions, my authorities can support the use of investment proceeds of SCA-2 resources.

Second, the sunsetting option has the benefit of allowing for a higher level of commitments. However, I do not find it advisable to use GRA resources for a prolonged period of time. A self-sustained ESAF would also preserve the corpus of the SDA resources.

Third, regarding the HIPC Initiative, the staff makes convincing arguments in favor of the use of escrowed loans on extended maturities for Fund participation in the initiative. Furthermore, I think that the option of making grants sets a new precedent that is not appropriate for a monetary institution.

Mr. Mirakhor made the following statement:

I am pleased once again to express my authorities' continued and full support for a continuation of ESAF. They are now studying ways in which they can financially support ESAF, including through SCA-2. Today you have received from one of my authorities a pledge of support. As others make it known, I will report to the Board.

> Of the financing options, our preference is for Option 1, but we are persuaded by Mr. Evans's argument and believe that, given the uncertainties surrounding the forecast, larger but still moderate amounts of gold investment may be required. We are not attracted by the sunsetting option but are persuaded by Ms. Lissakers's arguments and could agree, until resource needs and supplies are clear, to keep the SDR option on the table.
>
> On the HIPC Initiative, we believe that, whatever the modality, the HIPC Initiative should not reduce availability of ESAF and, moreover, that no country should be excluded if it meets the debt-relief criteria. Given the preferred creditor status of the Fund, we urge the Paris Club creditors to accept a 90 percent net present value debt reduction, and also encourage the Managing Director to argue the case in his upcoming meeting in Europe. On modalities, we prefer the escrowed loan option but could agree for the escrowed grant option to also remain on the table.

The Chairman stressed the importance of reaching agreement on ESAF financing in the Executive Board of the Fund. While some might hope that the forthcoming Lyon Summit of the Group of Seven (G-7) would result in an agreement on the ESAF financing, he would caution that the ESAF financing issue was not likely to be resolved at Lyon. After all, the G-7 heads of state would be discussing other issues of global significance as well, and they could not be expected to dwell on the technical details of the ESAF financing options. He would be addressing the G-7 leaders and holding private discussions with the leaders, and he hoped to be able to present to them the Executive Board's decision on financing the ESAF. Thus, he would urge Directors to reach agreement on the matter quickly.

Mr. Mirakhor said that he was optimistic that the Lyon Summit would yield progress on the issue, particularly as the ESAF was the centerpiece in the Fund's strategy to assist the heavily indebted poor countries. From the views expressed by Directors that morning it would appear that there was broad agreement on two issues: first, there was strong support for continuation of the ESAF, and second, there was also strong support for the Fund's involvement in the debt initiative. The Managing Director in addressing the G-7 should stress those two points. The only unresolved issue was the financing of the ESAF. Considering the substantial progress that they had made thus far, he was confident that they would also reach agreement on the financing issue. He recalled that the discussions on SDR allocations had it much more divisive than the current ESAF discussions.

Mr. Vernikov made the following statement:

> With regard to the ESAF financing operations, this chair told the Interim Committee that we would welcome any majority-supported decision that would not affect the Fund's financial integrity. In particular, we are prepared to move in the direction of a general consensus on the use of the resources of the SCA-2. If, and to the extent that, no other source of subsidy financing is feasible, we would no longer object to the use of investment income from a modest sale of the Fund's gold.
>
> As for the use of the GRA resources to finance the principal of ESAF loans in the interim, there is, apart from the policy issues discussed by previous speakers, another issue on which we need more information before making a

final judgment. The use of GRA will increase the Fund's exposure to borrowers of ESAF-type loans and thus might bring about the need to increase precautionary balances. Then all Fund borrowers, including low-income countries, would end up sharing the burden of ESAF financing.

The staff has recognized (EBS/96/76, page 9) that this may become an issue under the options entailing the use of GRA resources. It would be helpful to see any quantitative estimates of how considerable such a burden might be.

With respect to the debt initiative, I welcome the first attempt at putting on paper the proposed mechanism of debt relief. The scheme in its present shape requires further elaboration and analysis, given that we need to arrive at a clear understanding of the merits and drawbacks of each proposed modality (escrowed loan, etc.).

We appreciate a certain flexibility of the plan, namely that illustrative calculations are made for two options—80 percent and 90 percent reduction of net present value of claims. As a large creditor to several of the HIPCs, Russia is very much interested in a successful resolution of their debt problems and a restoration of external viability. While in the case of Nicaragua a lot of goodwill was demonstrated, I believe, however, that it is premature to build identical assumptions into the scenarios for other poor countries with large debts to Russia, as the staff has done for Ethiopia. Especially, there is no reason to assume that those debt agreements will be achieved irrespective of the debt initiative or beyond its framework. Bilateral and multilateral efforts must be linked into one framework and go in parallel.

Finally, I have a small terminological suggestion, with regard to the term "GRA-sunsetting." Indeed, it is the SDA, not GRA resources, that will finally be depleted under this scenario. Therefore, it might be more precise to call it "SDA-sunsetting."

Mr. Ismael made the following statement:

My authorities recognize that many ESAF borrowers have made substantial progress in their adjustment programs over the years. It is my authorities' firm belief that strong support for the continuation of the ESAF will prove instrumental in further assisting poor countries in their efforts to achieve sustainable growth in the long term.

Consequently, my authorities wish to indicate that, in principle, they support the Managing Director's proposal to finance the subsidy requirement during the interim period through gold sales and bilateral contributions, including the use of refunds from SCA-2. They would be willing to put up their share of the bilateral contributions, provided industrial countries also commit proportional shares. They will be considering the options most suitable for them after the commitments from the industrial countries become clearer. Nevertheless, as I try to read the green, Option 1(a) will most probably be seen as the optimal choice, while the sun setting option will probably be viewed as a last resort when all else fails.

While continued availability of ESAF will be instrumental in further assisting poor countries, it is not a sufficient means to help this category of countries, who are at the same time heavily indebted, to grow out of their debt and achieve sustainable growth. For these countries, the availability of ESAF as a loan is not a substitute for the need for debt relief. To this end, the Fund should be more concrete in its debt relief proposals. It should have been stated more clearly that a proportion of the gold sale has to be put aside to reduce the stock of debt. With the present apparent inclination to accord priority to achieving the ESAF financing requirement, resources to finance the HIPC Initiative could possibly become inadequate. Therefore, it should be stated clearly what other options would be contemplated to finance the HIPC Initiative. I, therefore, welcome the Director of the Policy Development and Review Department's oral clarification in this regard. I can also support, in principle, Ms. Lissakers's, Mr. Evans's, and Mr. Grilli's views on this matter. I would welcome the staff's concrete reformulation of the Fund's proposals for resolving the debt problem of the HIPCs, building on those views mentioned earlier.

Mr. Autheman made the following statement:

My authorities are in a listening mood. They try to catch, in views expressed by other countries, suggestions that could help narrow differences. Let me comment on two important issues which they think have to be part of a final compromise, and then elaborate on a few other specific items.

They strongly believe that SCA-2 has to be part of a final compromise. I think this is an area where the miracle can only come from the Board, considering the high technicity of the issue. No one has challenged the fact that it would not be appropriate to refund SCA-2 to the creditors. So there has been a general understanding that we should find a device to use them to the best. We have seen, lastly with the German paper, that there was widespread interest in using an SCA-2 refund to contribute to subsidy requirements. Therefore, we must find a way to use the SCA-2 to build a reasonable burden sharing framework which would free the willingness to provide bilateral contributions.

I had been left disappointed, in our previous discussion, by the very strong statement by the staff that the two approaches—refunding SCA-2 to members or retaining SCA-2 by merging it with SCA-1—were mutually exclusive. Therefore, I would be interested to learn more about the innovation you introduced earlier in our discussion. Clearly, if it were possible to have some form of option between merger and refunding, I think we could achieve a major breakthrough, and I personally am convinced that under such a framework my country would be ready to provide bilateral contributions which would go further than simply redepositing the refund.

We have also come to the conclusion that we will not be able to meet all the needs through only bilateral contributions and similar resources. In this regard, the paper circulated by Mr. Schoenberg, while showing a welcome move on the part of the German authorities, confirms that one cannot credibly build an agreement on this limited basis. One has to be very optimistic to think it is possible to collect SDR 1.3 billion in bilateral contributions, directly or indirectly.

Furthermore, although I think Mr. Schoenberg has a good point in arguing that we may still have been overstating the lending needs, his proposal has accumulated risks in the opposite direction. So it shows clearly that we need to supplement bilateral contributions. Mr. Arthuis, during the Interim Committee, indicated that he would be ready to consider gold sales if it were sincerely and unequivocally demonstrated that no other solution was available. We have come to the conclusion that this is the case.

The difficulty has been very well illustrated, in my view, by Mr. Evans's statement.

The suggestion by Mr. Evans was that, as soon as we agreed to sell gold, why should we limit ourselves? Why 4 million ounces? If we need 8 million, let us go to 8 million. The Managing Director has suggested a rule of thumb, which is a parallelism. I think we should show greater discipline and treat the gold reinvestment as supplementary and residual resources, in order to bridge the gap between our best assessment of the need and our best assessment of the bilateral contribution which we can collect if we agree on an SCA-2 framework which will help us to optimize it. It is very difficult for countries, which have to explain to a public opinion concerned by the prospect of the Fund selling gold, that we have not built strong limits to the expansion of this option. Therefore, I think we should move away from the idea of parallelism and toward the idea of residual contribution.

I have another comment on the question of the size of the need. I think Mr. Schoenberg is stretching the present ESAF arrangement a little too far by adding one or two years, unless he thinks the German Parliament will soon come up with the subsidy we had hoped for when we enlarged the ESAF. Of course, in this case his analysis would have great credibility.

On the contrary, I think he is right to point out that it does not make a great difference whether the permanent ESAF will begin in 2005 or in 2004. If my calculations are right, we need to accept a very limited decline in the protection of the creditors, which would not require a gold pledge; and the amount of a self-sustained ESAF would not be much lower— maybe 30 to 40 million per year.

While I would be reluctant to consider a scheme where the interim ESAF would start later, I think we should not exclude the option of a somewhat earlier start of a self-sustained ESAF. Of course, this is related to the question of how we contribute to the HIPC Initiative. Indeed, I must say that I have found the staff paper disappointing, because it is offering us very unpleasant tradeoffs. Either we agree to reduce the self-sustained ESAF or we agree to use lavishly our gold stock.

In all four schemes presented, the staff assumes that there will be a gold pledge. Quite frankly, I do not see how we could have it both ways: a gold sale with a re-investment and a gold pledge. I think we can have one of them, but we cannot accumulate the ways to use our gold stock. I think we have a very serious difficulty, since we cannot expect to find more resources.

Another point is the striking vulnerability of the analysis. There are a few countries for which at this stage we have had maybe four or five analyses: in the joint Fund and Bank papers and in Article IV discussions. From one analysis to the other, the country moves above or behind the 200 percent threshold. So we have a methodology to analyze the situation of a country, which is extremely useful, but which shows a great weakness in guiding our decision making.

How can we ask governments to build a new Paris Club framework on the basis of an analysis which would be provided by the Fund and the World Bank, let us say in 1999, and which would commit to actions being taken from 2002 onwards, while we know in three months we may reach a different conclusion? I think it has been extremely useful to build a joint framework, but to conclude that one threshold should be a decisive criterion for action is something which is quite uncomfortable. Indeed, all past debt initiatives have been designed as obligations to achieve some means but never as obligations to achieve results, knowing that we cannot eliminate the uncertainty of what happens in countries.

Finally, it would be useful for me and my authorities to know what the staff really has in mind. Is it a package surrounding our Zambia problem, which we have to deal with, or is it something more? We all know that we have a huge claim on Zambia, since we consolidated interest, which has never been paid, and we have to handle it ourselves; we cannot ask the other creditors to do it. I have the impression, reading the paper, that this Zambia case is a big share of what the staff has in mind. Therefore, maybe we should consider dealing with it in a straightforward manner and not calling it our contribution to a great HIPC Initiative. We also have to think of how we will be judged a few years later if people discover that what we called our contribution to a new initiative was our contribution to our own special problem.

The Chairman remarked that the debt initiative was aimed at assisting a number of heavily indebted poor countries and not only Zambia. It was true that the largest proportion of Zambia's debts were to the Fund, but there were other countries that were primarily indebted to other multilateral and bilateral creditors and the Fund would also be assisting those countries.

Mr. Kaeser made the following statement:

In order to find a consensus on ESAF and on the HIPC Initiative, I wonder what would be the best: whether I speak or remain silent. As a matter of fact, I was not able to obtain new guidance from my authorities, so the official position of this chair can be characterized as "no change."

But as we are asked if we can in our personal capacity recommend to our authorities the framework proposed by the Managing Director, I have to be honest and say "no."

I certainly admire the efforts made by management and the staff to solve the problem of financing the interim ESAF and the Fund contribution to the HIPC Initiative. But I am by no means convinced by the results.

Let me list some points of concern and of disagreement.

First, I still wonder why we try to provide a one-time solution to an ever recurring problem. It seems clear to me that after the completion of the HIPC, poor countries will again and again become over indebted, if only because state-guaranteed or financed trade credits will still be readily available to them and also because the Fund will continue to provide ESAF credits to heavily indebted poor countries. The first reaction of the Fund after the start of the HIPC Initiative should have been to ask bilateral creditors to reduce their claims even before we embark on new ESAF agreements with heavily indebted countries. The ongoing evaluation of ESAF will certainly show that the ESAF programs are not as successful as they should be because the supported countries have too high a debt burden.

Third, the records of our discussions show that I was always against merging the financing of the interim ESAF and of the HIPC Initiative. The relatively moderate size of the likely contribution of the Fund to the HIPC shows that it would have been possible to solve the HIPC financing separately. It would have been possible to collect bilateral contribution for such a noble initiative widely supported by the nongovernmental organizations (NGOs).

According to an Anglo-Saxon maxim, we should cross the bridge when we get to it. The uncertainties under which we are planning for ESAF operations and the HIPC Initiative are great because we try to cross the bridge before we ever see it. I still have difficulty to understand why we are in such a hurry. The most likely answer is that the HIPC Initiative is at the core of the agenda of Oxfam and other NGOs. One result of such hurry and of such uncertainties is that the decision paper provided to governments that are busy to solve day-to-day problem are quite surrealistic.

As to the sale of gold, I am personally rather open minded, but I am against any operation devised to make good for the lack of bilateral contributions in the ESAF financing. In my view, the decision to sell or not to sell gold should be part and portion of the Fund policy relating to the management of its assets. If it makes sense to sell gold, yes perhaps sell large quantities of gold and invest the proceeds. The most important aspect of the management of the Fund assets should be the maintenance of their real value, which is not secured in the proposed framework. As far as the principle of the maintenance of the real value of our assets would be firmly secured, I would personally not object to the sale of large quantities of gold. Once the maintenance of the real value of our assets would be secured, the surplus of the earnings could be used to replenish ESAF or to take over the part of IDA which is currently used for balance of payment financing.

The Director of the Policy Development and Review Department noted that the costs of the HIPC Initiative were central to the discussion. The costs to the Fund of the HIPC Initiative would be in addition to the costs of placing the ESAF on a self-sustained footing. Thus, either additional resources would have to be raised for the HIPC Initiative, or, if SDA resources were used for the HIPC Initiative then the amount of lending under the self-sustained ESAF would be lower. On the initiative itself, he would note that the paper did not intend to establish a fixed list of eligible countries. The earlier exercise had classified 41 countries as "sustainable," "possibly stressed," or "unsustainable." The report by the Managing Director and the President of the World Bank to the Interim and Development Committees had stated quite clearly that the results of the debt sustainability analysis should not be taken to prejudge eligibility under the proposed initiative. The intention was that, when the 20 countries that were identified as being "unsustainable" or "possibly stressed" had completed the first stage of the adjustment process, the debt sustainability analysis for those countries would be redone, and, on that basis, a decision would have to be made whether a country could "exit" from the debt rescheduling process with Naples terms or whether it would require additional assistance. The staff in its preliminary analysis had found that 13 countries would need additional measures beyond Naples terms to enable them to attain sustainability. The staff was not prejudging which of the 20 countries would be eligible for additional debt relief, because some of the countries might not be able to sustain the adjustment process and therefore they would not be eligible for the additional mechanisms. At the same time, some countries might be in a more vulnerable position than assumed. The nature of the exercise was such that there was a considerable amount of uncertainty about the number of countries that would need assistance beyond the current mechanism and the costs of providing such assistance. It would be up to the Executive Boards of the Fund and the Bank to decide which of the two adjustment stages a country was in. The staff had assumed for illustrative purposes that Mozambique was at the beginning of the three-plus-three stage. The Board could decide that Mozambique was further along the adjustment process—notwithstanding the slippages—and accordingly the costs of the HIPC Initiative would need to be determined. The three-plus-three adjustment process was to be applied flexibly depending on the circumstances of individual countries.

The staff had assumed a net present value debt/export ratio of 200 percent and a debt service/export ratio of 20 percent for illustrative purposes only, the Director continued. If the threshold were raised to 225 percent for the debt/export ratio, the total cost of the HIPC Initiative would decline to US$ 3.7 billion and the costs to the multilateral institutions would decline from US$2 billion to US$700 million. There were differences of view among Directors about the appropriate threshold levels; the staff had proposed that the threshold for the debt/export ratio should be in the range of 200–250 percent and for the debt-service/export ratio it should be 20–25 percent. The actual threshold chosen would depend on the so-called "vulnerability" factors, such as the level of reserves of a country and its vulnerability to commodity price swings, debt service as a proportion of the budget. Central to the projections was export performance. Some Directors were of the view that the staff had been unduly optimistic in its projections of export performance. It was true that there was considerable difference in export performance in 1990–94 and the staff's projections for 1996–2000. The export growth rates for the 20 countries that might be eligible for the debt initiative was 3.3 percent on a weighted average basis in the 1990–94 period, and the staff was projecting that the export growth would be 6.5 percent for the 1996–2000 period. However, it should be borne in mind that in the earlier period, Zambia had had negative growth rates, Zaïre had had a negative export growth rate of 13.9 percent, and Rwanda's exports had fallen by 25 percent. Thus, the figures for the 1990–94 reflected export growth for countries that had experienced severe disruption in that period. Export performances of countries that had undertaken adjustment measures in the 1990–94 period were not substantially different from the staff's projections of export performance in the 1996–2000 period. The assumption was that, as countries undertook adjustment measures, exports would pick up. The staff agreed with Mr. Grilli that it was also possible that export growth could be higher than assumed.

As he had stated earlier, the cost to the multilateral institutions was the same irrespective of when the contributions were effected, the Director remarked. The Fund would be contributing in proportion to its exposure in the country concerned. With respect to the modalities of the Fund's contribution, the staff had suggested the escrowed loan approach as it provided more flexibility to smooth the country's external debt-service profile compared to the escrowed grant approach. The staff agreed with Directors that, from a public relations perspective, the grant approach was preferable. That was an important factor that should be taken into consideration. Both modalities—the escrowed loan and escrowed grant—should remain open for consideration. In some cases, an escrowed loan would be a preferred approach; in other cases, an escrowed grant would be the preferred approach.

The staff had met with the staff of the other multilateral institutions, and the Managing Director had had meetings with the heads of a number of those institutions, the Director noted. The staff in those institutions were considering ways for them to participate along the lines of the Fund and the Bank, that is, in a manner that would reduce the net present value of the institutions' claims. Under current estimates, the cost to the African Development Bank for participating in the HIPC Initiative was US$400 million. At present, it was not clear how the African Development Bank would participate, given the internal restructuring it was undergoing. There was a possibility that, if the World Bank were to establish a multilateral fund, other multilateral development banks could join in the Bank in contributing to that fund. The option of securing bilateral contributions for the multilateral fund was under discussion and mixed views had been expressed on that in the World Bank's Board.

The staff had prepared a paper on the coverage of the debt rescheduling by the Paris Club, and could circulate it if Directors so wished, the Director stated. While the Naples terms provided for a net present value reduction of up to 67 percent on eligible debt, in most cases, the net present value reduction was significantly lower. There were two reasons for that. First, the net present value reduction applied to eligible debt only, which excluded post-cutoff date debt. Second, the net present value reduction under Naples terms for official development assistance (ODA) was likely to be less than 67 percent as pre-cutoff ODA debt was generally rescheduled over 40 years, with a 16-year grace period, with an interest rate as concessional as the original interest rate. The post-cutoff date mechanism had performed a useful function because it had allowed a continuous flow of short-term credits and trade credits, notwithstanding debtors' appeals to creditors for debt relief. Whether debt reduction should also apply to post-cutoff date debt was an issue that should be considered carefully. In most cases, that would not have a significant impact on debt burdens. Owing to those two reasons, the effective debt relief under Naples terms was 50 percent, and the staff considered that if the Paris Club were willing to provide debt relief of up to 90 percent, the effective relief would be about 80 percent.

If ESAF loans in the interim period were financed though the GRA, arrears would be treated as they were currently, and there would be no need to invoke the gold pledge, the Director noted. However, if ESAF loans were financed through bilateral contributions, and a borrower failed to make repayments, the gold pledge would need to be invoked, if it were decided that the resources of the Reserve Account were not to be used to repay creditors. The Board had on earlier occasions discussed whether the gold pledge should be the first or last line of defense, but no decision had been taken. The staff had on those occasions suggested the possibility of having gold sales as a first line of defense in order to keep intact Reserve Account and SDA resources to finance the self-sustained ESAF.

It was true that the Fund was the major creditor to Zambia and would be making a substantial contribution toward reducing the net value of its claims on Zambia, the Director of the Policy Development and Review Department stated. That was the nature of the exercise, and, in other cases, other multilateral and bilateral creditors would be contributing in proportion to their exposures in the country in order to reduce the net present value of their claims. With respect to Mr. Schoenberg's proposal, he would note that stretching current ESAF resources to 2001 would mean rationing access and increasing conditionality, in view of the lower level of financing available. Some Directors had questioned the staff's estimates of demand for the 1996–99 period. However, the staff had been cautious and had revised its demand projections on numerous occasions. Indeed, the staff had already "stretched" current ESAF resources from 1998 to 1999. The demand for ESAF resources in the first half of 1996 suggested that the staff's estimates were correct. Thus, the staff was confident that its estimates were an accurate projection of demand for the period until 1999.

Ms. Lissakers asked whether the projections on demand for ESAF resources both in the interim period and beyond that were based on the assumption that those countries benefiting from the HIPC Initiative would not be using ESAF resources.

The Director of the Policy Development and Review Department replied that, for the period beyond the interim period, that is, after 2004, the staff had assumed that those countries benefiting from the HIPC Initiative would not be using ESAF resources. That "netting out" process was based on the assumption that countries' balance of payments situation would be better than it would have been in the absence of the initiative, and thus, the estimate of their expected use of ESAF resources in the period after 2004 had been lowered. The savings in terms of the related subsidies on loans, that would otherwise have been extended, were "netted out" from the calculations of the impact of the HIPC Initiative on ESAF resources.

Mr. Grilli observed that there were two types of risks related to estimates of the cost of the HIPC Initiative. One was the inherent uncertainty in making those kinds of projections, which, by its very nature, was unavoidable. A second type of risk—which was avoidable—related to the number of countries that were considered eligible under the HIPC Initiative. In his view, the risk of the costs escalating was compounded if more countries were added to the list. Thus, only those countries with "unsustainable" debt burdens should be eligible for debt relief under the proposed initiative, and it should not be assumed that those countries that were "possibly stressed" would be eligible. Those cases should be treated strictly on a contingency basis, to avoid the impression that they would automatically be entitled to debt relief under the initiative.

The Chairman said that he agreed that it was extremely difficult to predict the costs of the HIPC Initiative, in view of the enormous uncertainties involved in making such projections. At the current stage it was difficult to have more precise estimates. The Fund could contribute to some extent in alleviating the debt burdens of the HIPCs, and would move forward in conjunction with other creditors. While progress had been made on a broad framework on the basis of which they could proceed, they would need to work toward finalizing the details of the framework. Only in a spirit of compromise would they be able to reach agreement on the subject. However, he was confident that they were close to an agreement.

One of the issues that remained to be agreed was the financing of the loan component in the interim period, the Chairman stated. Together with the staff, he would take all the steps needed to raise bilateral contributions toward that. A second unresolved issue was the financing of the subsidy component. A number of Directors had indicated their constituencies' willingness to make bilateral contributions— including through the use of SCA-2 resources—which was an essential part of the burden sharing among the membership. It should be possible to both merge SCA-2 resources with SCA-1 resources in the GRA, as well as refund SCA-2 resources to members, depending on the needs of individual SCA-2 contributors. If bilateral contributions—including SCA-2 resources—were large enough to meet more than one-half of the subsidy component of the interim ESAF, the Fund would need to sell even less than the 5 million ounces he proposed. That would allay the fears of those Directors who were concerned about gold sales. A combination of the financing modalities would take them closer to a solution. It should be borne in mind that the Interim Committee had called for reaching agreement on a financing proposal, which Ministers could consider at the fall meeting. Toward that end, it was important that members provide precise information about the extent of their bilateral contributions by September 1, 1996. That would give then time to put in place the other elements for financing the ESAF and would allow the Board to consider ESAF financing options prior to the Interim Committee's meeting.

Mr. Evans said that he welcomed the Chairman's remarks on use of SCA-2 resources. He would have liked to believe that they were closer to an agreement, but considered that it would take some time to agree on a financing option that could be supported by all. According to the staff's projections, after account was taken of the HIPC Initiative, the self-sustained ESAF was projected to support disbursements of about SDR 0.6 billion, which was much lower than the projected demand for those resources in that period.. Those issues would need to be resolved before any agreement could be reached.

The Chairman considered that central to the calculations was the contribution by the Paris Club to the HIPC Initiative. Agreement on the ESAF and HIPC Initiative would be reached quickly, if the Paris Club were to agree to a net present value debt reduction of up to 90 percent. Contributions from other bilateral and commercial creditors were also necessary in order to preserve the preferred creditor status of the Fund.

Ms. Lissakers and Mr. Waterman asked for clarification regarding the legal aspects relating to the use of SCA-2 resources.

The Chairman stated that it should be possible to both merge SCA-2 and SCA-1 resources, if some members wished, and refund SCA-2 resources to those members who preferred to receive refunds rather than allow their share of SCA-2 resources to be merged with SCA-1. The merger of some members' SCA-2 resources with SCA-1 resources and the refunds of other members' SCA-2 resources to them would require a 70 percent majority in the Executive Board and a unanimous consent on the part of SCA-2 contributors.

Ms. Lissakers considered that it would be useful to have a short statement on the details of the proposal relating to the use of SCA-2 resources.

Mr. Mirakhor asked whether the proposal to merge some members' share of SCA-2 with SCA-1 and refund other members' shares of SCA-2 was in recognition of the domestic legal difficulties some members might encounter in making available SCA-2 resources for the ESAF.

The Chairman considered that the issue was whether members were willing to contribute to the ESAF and, if so, which modalities they preferred in making available their contributions. It was in that connection that he suggested that members could choose whether they preferred to merge SCA-2 with SCA-1 or whether they preferred to receive SCA-2 refunds, which could form part of their bilateral contributions to the ESAF.

It would be useful if they could meet again the following week to further consider the ESAF financing options, the Chairman suggested. He would ask Directors to speak in their personal capacity and indicate whether they could recommend any of the financing options to their authorities.

Mr. Schoenberg considered that differences remained on the financing elements for the ESAF, and it was necessary to bear those differences in mind for future discussions. On the availability of ESAF resources, rather than trying to raise sufficient resources to meet projected demand, it might be useful if the demand for ESAF resources were tailored to meet the supply of resources. On SCA-2, he wondered whether it would be possible to take a decision on future use of those resources prior to the expiration of the rights approach.

The Chairman stated that the staff would study further the legal aspects related to the use of SCA-2 resources. On the demand and supply of ESAF resources, he noted that the staff had often adjusted the amount of resources available to individual members depending on the overall supply of resources. In his view, underfinancing of programs was detrimental to members' "ownership" of programs and to the success of the programs. Moreover, the resources under the self-sustained ESAF were entirely supply driven and not determined by the demand for ESAF resources.

The Chairman made the following concluding remarks:

> While several issues have been clarified, a consensus is still to be reached on the financing options for future Enhanced Structural Adjustment Facility operations, including the specific modalities for the Fund's

participation in the heavily indebted poor countries initiative, before presenting proposals to the Interim Committee.

Directors restated their universal support for the ESAF as the centerpiece of the Fund's strategy to help low income poor countries, including in the context of the proposed HIPC Initiative. They also agreed that the possible participation in the HIPC Initiative should take place through special ESAF operations financed from Special Disbursement Account resources. Many Directors reiterated that the Fund's participation in the HIPC Initiative should have at most only a relatively modest impact on the level of regular ESAF operations. Therefore, we should aim to raise sufficient additional resources for the ESAF to assure this result.

Most Directors supported a temporary use of the General Resources Account resources for financing the principal of ESAF-type operations during the period 2000–04 before the start of a self-sustained ESAF, thus striking a reasonable balance in preserving the monetary character of the Fund and assuring a level of annual ESAF commitments in line with the expected needs of the poorest members.

A few Directors continued to favor options that do not involve the use of GRA resources, proposing a combination of a stretching out of resources of the current ESAF, an early start of the self-sustained ESAF, and, if needed, a very short interim period with ESAF operations financed from new bilateral loans. Other Directors did not consider it desirable to undertake a further round of bilateral lending to the Loan Account of the ESAF Trust, given the potential magnitude of the gold pledge that may be required to provide protection for existing and new lenders to the ESAF Trust. They also considered that proposals based on a stretching out of current ESAF resources would not provide sufficient resources to deal with the demands foreseen for the ESAF and for the Fund's participation in the HIPC Initiative.

Directors supported continued efforts to mobilize a significant level of bilateral contributions for subsidies, including in the form of use of the second Special Contingent Account resources to ensure an adequate level of future ESAF operations while preserving the Fund's SDA resources and gold. I was gratified to hear many Directors provide encouraging indications about their authorities' willingness to make bilateral contributions, including through SCA-2 resources and subsidized loans. I understand and appreciate their desire to see a collective effort to reach an adequate level of contributions. Other Directors, however, saw difficulties in securing bilateral contributions, including at this stage from their own authorities.

Directors continued to have differing views about how to cover any subsidy requirements that would remain after bilateral contributions. A few Directors remained opposed to the use of part of the Fund's gold to generate investment income on the profits from gold sales. Others had difficulty with an early use of SDA resources as it would imply a lower level of self-sustained ESAF operations and, possibly, a gold pledge to substitute for reduced security for existing ESAF Trust creditors. These issues will need further consideration, taking into account the need for resources to finance the Fund's contribution to the HIPC Initiative.

Directors generally did not favor sunsetting options, as they would imply a full exhaustion of SDA resources, the use of GRA resources over an extended period, and the possible need for an increase in the precautionary balances in the GRA. It was noted, however, that the choice between sunsetting and a self-sustained ESAF could be made at a later stage as we approach the end of the interim period.

Directors took note of the preliminary joint Bank-Fund analysis of the costs of the HIPC Initiative to lower the debt burden of a minority of heavily indebted poor countries for which current debt-reduction mechanisms are insufficient to achieve debt sustainability, and they welcomed the incorporation of the possible costs to the Fund into the ESAF financing options.

They broadly accepted the factors affecting the costing and—while noting the many uncertainties—found the preliminary estimates of the total costs of the initiative a good basis for further analysis. Directors generally found the range of estimates of the possible costs to the Fund under different scenarios broadly realistic, and they noted the sensitivity of the calculations to a number of factors, including the assumption of the net present value debt reduction by official bilateral and commercial creditors, the group of eligible members, and whether members would actually qualify for assistance. Some Directors were of the opinion that a realistic reduction in the debt burden of the heavily indebted poor countries would require a stronger effort from all creditors involved, including from the Fund. Some other Directors, however, viewed the estimates of the costs of the initiative, including the costs to the Fund, as unduly high, and suggested a more stringent use of the criteria determining the amount of envisaged net present value debt reduction for the eligible countries.

A number of Directors expressed concern that the possible Fund contribution to the initiative would reduce the level of self-sustained ESAF below a level that could be considered a minimum, given the potential demand for ESAF resources from our low-income members. Several Directors were of the view that the calculations of the impact of the HIPC Initiative—even under options where the impact was small—demonstrated a need for additional resources from the Fund or from bilateral contributors to top up the level of self-sustained ESAF operations to a level in line with potential demand.

Directors saw merit in both the escrowed loan on extended maturities and the escrowed grant as modalities for achieving a targeted debt reduction in net present value terms through the ESAF. It was noted that the choice—including a possible combination of modalities—could be kept open for each country that might be eligible for a contribution from the Fund under the proposed initiative.

After some discussion, it was agreed that the Board would consider further the ESAF financing options and the HIPC Initiative on Wednesday, June 19, 1996.

3. NIGER—1996 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1996 Article IV consultation with Niger and Niger's request for arrangements under the Enhanced Structural Adjustment Facility (EBS/96/10, 1/25/96; and Sup. 1, 5/29/96). They also had before them a paper containing background information (SM/96/47, 2/27/96) and a policy framework paper for the period 1996–98 (EBD/96/9, 1/26/96).

Mr. Koissy made the following statement:

> My Nigerien authorities would like to express their appreciation to the management and the staff of the Fund for their understanding of the difficult circumstances being experienced by Niger since 1995 and also for their assistance in the preparation of the proposed economic and financial adjustment program for which Fund support is requested under the ESAF. They fully concur with the staff analysis and recommendations and agree that the achievement of sustainable growth and the reduction of poverty will require major macroeconomic and structural reforms efforts.
>
> Directors will recall that following the realignment of the CFA Franc parity in January 1994, Niger started to implement a Fund-supported Stand-By Arrangement program. However, rising political tensions and strikes made it difficult for the authorities to continue with the program as envisaged. In spite of this difficult environment, the authorities remained committed to the adjustment process, and with the assistance of the Fund staff, an emergency recovery program was put in place and aimed at strengthening budgetary revenue and reducing the budgetary deficit, and also preparing the ground for a more comprehensive adjustment program that could eventually be supported by the Fund under an ESAF arrangement.
>
> Progress was achieved under this emergency program: real GDP grew by 3 percent in 1995, inflation dropped down to 7 percent by year-end, and the current account deficit, excluding grants, was reduced. The fiscal position improved as revenue/GDP ratio increased significantly to 7.2 percent while the wage bill which stood at more than 100 percent of government tax revenue in 1994 was brought down to 80 percent and the government domestic arrears to public utilities were significantly reduced. Furthermore, domestic arrears were converted into domestic debt and in this context, treasury bonds were issued to clear wage arrears and some other arrears to domestic suppliers.
>
> Against this background, my authorities started negotiations with the Fund and the World Bank on an ESAF-supported program. The main objectives and policy measures are as described in the policy framework paper and the authorities' Memorandum of Economic and Financial Policies circulated in January 1996 as EBD/96/10. However, while political

developments in Niger caused a delay in the presentation of the report to the Board until now, it should be noted that the authorities maintained the thrust of the adjustment efforts and continued with the implementation of the program.

The key objectives of this three-year economic and financial program remain further progress in macroeconomic stabilization, the promotion of an appropriate environment for sustainable economic growth, and the reduction of poverty. This program aims at achieving during the period 1996–98 a real GDP growth rate of over 4 percent, stabilizing inflation rate to about 3 percent, and limiting the external current account deficit, excluding official grants, to less than 11 percent of GDP by 1998.

In line with this strengthened medium-term strategy, the program for 1996–97 focuses on laying the conditions for raising real GDP growth to 4.2 percent, containing the inflation rate to about 3 percent, through restrictive wage and financial policies, while lowering the external current account deficit, excluding official transfers, to 11.5 percent of GDP. To achieve these objectives, my authorities will implement appropriate economic measures in the area of public finance, money and banking and to pursue the structural reforms. In view of developments in first quarter of 1996, the original program has been strengthened and additional measures have been introduced to close an ex-ante financing gap that had widened relative to the original program.

In the fiscal sector, clear signals have been given with a view to improving performance. The overall fiscal deficit on a commitment basis is to be reduced from 9 percent of GDP in 1995 to 8 percent in 1996, through the implementation of revenue-increasing and expenditure-reducing measures. On the revenue side, measures including key recommendations of both the last Fund Fiscal Affairs Department technical assistance mission and the government working group seminars have been adopted in the 1996 budget in order to improve the tax system. As described in the staff supplement, important revenue measures have been implemented in early 1996 and included, among others, a property tax on owner-occupied housing, a single license tax which is expected to help bring the informal sector into the tax net, and a strengthening of tax and customs administration. These measures already taken, together with the others adopted in the budget, should result in an increase in budgetary revenue to 8.2 percent of GDP in 1996.

On the expenditure side, the measures focus mainly on streamlining budgetary outlays. In that connection, after consultation with the labor union, civil service salary for 1996 was cut by half. This measure will remain in effect through 1996. The enormous sacrifices that this measure entails should not be underestimated, given the already low level of wages in one of the poorest country in the world. But the consensus that was arrived at in taking this measure shows that the Nigeriens are conscious of the difficult economic and financial situation of their country and of the need to take unpopular but courageous measures so as to ensure better conditions in the future. The authorities will also maintain a strict control over the remaining current expenditure to assure availability of credit for other essential outlays including specific programs for an improvement of primary education and preventive health. Regarding capital expenditure, actions will be taken to improve projects programming and implementation in close collaboration with the World Bank.

In the monetary sector, my Nigerien authorities are committed to implementing, within the framework of the West African Monetary Union, a prudent credit policy, consistent with the program objectives. With the expected improvement in the fiscal position, the government envisages to bring the Treasury credit position with the central bank within the ceiling of the statutory advances and refrain from recourse to domestic bank financing.

In the external sector, the continued decline in the international prices of uranium is a matter of major concern, as it has adversely affected the country's economic and financial position. Notwithstanding this situation, the government expects that the timely implementation of the supporting structural and sectorial measures would help diversify the export base and strengthen the balance of payments position.

On structural policies, beyond the measures to improve tax administration and the effectiveness of investment project, my authorities are determined to press ahead with a civil service reform, including a modification of the labor code, a voluntary departure scheme and redeployment of civil service employees to meet the staffing needs of the priority sectors. Regarding the banking system reforms, my authorities intend to lay stress on updating the legal framework for credit institutions and procedures for bank claims recovery, banks audit, and financial sector restructuring. Reforms of the public enterprises will be speeded up and inventory of cross debt among the public enterprises accelerated. In this regard, a privatization law has just been decreed.

Finally, my authorities are well aware of the magnitude of the challenges ahead. They believe that they have clearly demonstrated their determination to continue the adjustment process by taking the necessary measures during a very difficult period. However, it is clear that the success of the program will be facilitated by the availability of external financing assistance on concessional terms, as noted by the staff. In this context, the authorities appreciate the indication given by donors that their financial assistance will resume in conjunction with an ESAF-supported program.

Extending his remarks, Mr. Koissy indicated that, as of June 1, 1996, jointly with the other member countries of the West African Monetary Union, Niger decided to accept the obligations of Article VIII of the Fund's Articles of Agreement. The Managing Director had been notified of the decision.

Mr. Kiekens made the following statement:

Niger's decision to undertake a multiyear adjustment with the support of an ESAF arrangement has the potential to put the country on a more sustainable growth path, although the present high rate of population growth will limit per capita income gains. This Fund-supported program should foster political consensus and ease the process of democratization. I approve the proposed decision, which will harmonize well with yesterday's decision by the Council of Ministers of the European Union to resume partial assistance to Niger. I would like to make a few observations about the program.

Niger is a very poor country whose social indicators are among the weakest in the world, and with limited administrative capacity. The success of this program, however, critically depends inter alia on the implementation capacity of Niger's government, especially in the fiscal area. The country therefore badly needs external technical assistance to supplement its own implementation capacity. In 1994 and 1995, Niger only received two limited Fund technical assistance missions, one concerning government financial statistics, and the other a mission from the Fiscal Affairs department directly related to the preparation of the program before us today. Moreover, the Fund has no resident representative in Niger. I wonder if the staff of the Fund and the representative of the World Bank could give us any further information about technical assistance projects planned for this year, and tell us if they are aware of similar projects planned by other donors.

In 1996, the authorities are making a strong effort to compress the public sector wage bill. This is being accomplished primarily by reaching a wage agreement with the labor unions. It is critical that this wage compression should be sustained in the coming years, and I would therefore ask the staff to pay careful attention to this issue when discussion next year's budget.

Containment of the public sector wage bill will set an example for wage moderation in the private sector and enhance the competitiveness of the economy at large. It will also free up public resources to address basic needs in the health and education sectors. To take best advantage of these resources, numbers of public employees should be redeployed to these sectors. To this end, I urge the authorities to complete the reform of the civil service as soon as possible.

It would be interesting to learn whether the results of the World Bank's survey indicate whether the target of reducing the size of the public sector by 2,000 employees is sufficiently ambitious, and whether the voluntary departure program chosen as the main instrument for achieving this objective is adequate. Finally, I note that scholarships now account for almost 5 percent of the total current budgetary expenditures, and that many irregularities have been observed in this sector. There is an evident need to further improve the administration of these scholarships.

Improving the collection of revenues will be another key element for the success of the program. Let me note that today's ESAF program aims at increasing government revenues for 1996 by one percent of GDP, to 8.2 percent of GDP. By comparison, the 1994 stand-by program, which was not completed, aimed at increasing revenues to about 9 percent of GDP by the end of that program. Since 1994, the authorities have taken a series of measures to improve revenue collection, including a VAT tax and reformation of the income tax and customs administration. Until now, however, the political turmoil and administrative procrastination have prevented the expected increase in revenues from materializing. I hope that with the implementation of today's program, the these measures will finally begin to produce increased revenues.

How sure is the staff that the steep reduction of the Public Sector Borrowing Requirement under the program will result in an increase in the recovery of domestic savings by 4.5 percent of GDP and an expansion of credit to the private sector, essential for the achievement of higher growth in the medium term? Indeed, in the recent past the central bank was providing excessive credit to the government, while credit to the rest of the economy remained particularly low. Although the financial situation of the banking sector greatly improved thanks to the reforms implemented with the assistance of the World Bank, the commercial banks still seem reluctant to provide credit to private enterprises and households. Will the commercial banks be more inclined to lend to enterprise and households, once economic growth resumes and investment opportunities increase? Has the staff discussed any additional measures for increasing the propensity to invest in the domestic economy and facilitate its financing?

Let me conclude by expressing the hope that this ESAF program will finally enable Niger to take advantage of the two-year-old CFA franc devaluation.

Mr. Newman made the following statement:

Niger is a heavily indebted, poor country, which can ill afford policy slippages. Unfortunately, this is what has been occurring off and on for the past decade, and what happened most recently last January . As a result of political developments, much of the progress made last year in restoring domestic finances was set back. The proposed ESAF will essentially restore Niger to the position it should have been in four months ago.

My authorities have several reservation about approving the program at this time.

First, Niger's track record with the Fund is poor. As the first sentence of the policy framework paper states, despite several adjustment programs over the past decade, economic performance has been weak. Their 1994 standby went off track not long after the initial purchase. This ESAF was withdrawn not long before the Board was originally scheduled to consider it.

Second, there are still uncertainties about whether the program is adequately financed. Assistance from a number of donors is dependent on the authorities strictly implementing the current timetable for a return to democracy. As of today, there are still questions whether the authorities will adhere to this timetable. We believe that delaying consideration for a month, until after the first round of the presidential elections, would have given the Board a much better sense of the authorities' commitment to this timetable.

We do, however, recognize the concerns of other chairs about the need to go ahead.

The regional central bank's response to political developments during the first quarter is troubling. To offset the lost external financing, the bank provided the Niger government exceptional support and exceeded its credit limits by a substantial margin. To keep the money supply from increasing, the bank reduced credit to the private sector.

The Central Bank of West African States' (BCEAO) credit limit is an important signal to governments that its business is ensuring price stability, not financing public sector deficits. We understand that the bank might occasionally need to provide exceptional support to help governments adjust to external shocks. What concerns us in this case is that the bank helped offset the impact of a decision the government made on its own. Like the Fund, the BCEAO, as a lender of last resort, has to be very sensitive about how its actions affect moral hazard. One concern we have with the program is there are no assurances that this could not happen again. If I understand correctly from the staff, the program would allow increased credit from the central bank to offset up to 75 percent of any shortfall in external financing.

Regarding fiscal policy, we agree with the staff that raising revenues should be the centerpiece of a program. It is both unusual and commendable to see a contingency reserve set aside in the budget. Further wage restraint is probably unsustainable. Thus, it will be important that measures to reduce civil service employment are implemented as programmed. This will free up resources for education, health and rural development. While the new government was forced to cut wages to offset the loss of external financing, it has not yet demonstrated a willingness to implement broader reforms.

Regarding structural reforms, I was disappointed to see the authorities' commitment to "privatize" firms in 1996 only involves reducing the government's stake below 50 percent. Could the staff clarify whether this is the government's intention regarding firms to be privatized in 1997 and 1998. In commercial sectors, we see little justification for retaining a government ownership, even a minority stake. Furthermore, we question why the government needs to continue to retain full ownership of certain enterprises such as the pharmaceutical company (ONPPC).

I have a comment on the staff's assessment of Niger's debt burden. Even if official grants more than triple and Niger is able to: (1) fill financing gaps on concessional terms, (2) successfully complete this program, and (3) receive a generous stock of debt reduction at its conclusion, its external public debt burden will be, in the staff's words, "stressed." However, in the HIPC paper, the staff suggests that the exclusion of private debt and assuming private creditors provide relief to the full extent of available mechanisms, Niger's position could be sustainable.

To conclude, I understand the Deputy Managing Director will soon be in Niger. It is essential that he deliver the following message:

(1) It is absolutely essential that the authorities fully implement this arrangement as programmed. Niger's poor track record must improve significantly to warrant continued Fund support.

(2) The authorities must follow through on their commitments to fair and free elections in order to restore donor confidence and to secure essential external assistance.

Mr. Grilli made the following statement:

At the time of the ESAF program negotiations in December 1995 and after a period of poor economic management and performance, Niger seemed to be on the right track toward a macroeconomic adjustment process conducive to sustainable economic growth and poverty alleviation: the inflation rate has been substantially reduced, thus helping the country to maintain competitiveness gains brought about by the earlier devaluation of the CFA franc; encouraging process had been made in the fiscal area, owing essentially to the containment of the civil service wage bill and to a substantial improvement in budgetary revenues; and the external current account deficit has narrowed. Even though this process was interrupted by the January 1996 military coup, the renewal of a democratic process, and the implementation of the supplementary budgetary measures by the interim government, provide some reassurance that the authorities are capable and committed to resume program implementation. As result, major donors have already indicated that they are prepared to resume financial support after the establishment of a Fund-supported program.

However, the military coup, together with the earlier suspension of foreign assistance, significantly affected economic performance, in particular in the fiscal area, and a larger than initially expected financial gap has emerged. Therefore, if during the discussions for the original program, the staff had already concluded that the program, while not overly ambitious in its macroeconomic objectives, would impose a burden on Niger's administrative and implementation capacity, this statement is now even more poignant. In fact, the widening of financial gaps (by CFAF 30 billion relative to the original program) required some adjustments in the original program, which will fall on the tightening of fiscal policy, which, given the current exchange and monetary arrangements, is also the critical policy instrument for achieving macroeconomic stabilization.

Two areas are correctly considered as priorities in the staff report: the strengthening of the revenue collections, which at 7.5 percent of GDP in 1995, remains very low, even by regional standards; and a reorientation of public expenditures from the wage bill toward investment and social spending. Some important measures were already introduced aimed at broadening the tax base and at strengthening tax and customs administrations. Concerning the expenditure side, I agree with the staff that the decision to reduce the wage bill on the civil service by one-third is significant. However, in order to assure a sustained reduction in the ratio of personnel outlays to government tax revenues, the retrenchment of the civil service is also required.

The maintenance of a good track record of policy implementation, together with continued progress toward the return to democracy, is critical to guarantee the resumption of external assistance and the needed financing for the program. In this context, the implementation of structural reforms aimed at establishing an adequate environment to private sector development, in particular, the parastatal and privatization reform and the liberalization of the labor market should be considered priorities.

There is an aspect of the programs, to which previous speakers have also alluded, that I would like to have clarified: training. We are about to set up a fund program with a transition government less than a month before critical presidential elections. Would it not have been wiser to wait for the results and then verify the commitment of the new president to the programs before embarking on it? Given the small delay that this course of action would have implied, one can presume that the related costs would have been small while the credibility gains could have been considerable, especially vis-à-vis donors, thus helping the financiability of the program I am sure that management and the staff must have carefully weighed the pros and cons of the decision before coming to the Board. Can they make explicit the reasons why they considered coming now preferable to waiting a while?

Mr. Autheman made the following statement:

Let me begin by saying that I welcome this program and support it; and I think that it is time to approve it and give it a start. The situation in Niger remains extremely fragile. The past weaknesses, which have led to slippages at times of very unstable political situations, are still there. However, we should not overlook the significant progress which has been made in the recent past.

First, on performance as regards inflation, I know that the Fund staff is sometimes used to consider that rates of inflation of 20 to 25 percent deserve to be supported by ESAF programs. I personally think that this shows a sense of laxity on our behalf which does not help achieve lasting progress. It is quite remarkable to note that, in spite of significant slippages in other areas of policy, Niger, as well as other neighboring countries, has successfully stabilized inflation. Considering the magnitude of the external shocks to which its close economic relationship with Nigeria exposes Niger, I think this is an important achievement which we should not forget.

The second element is the progress in revenue collection in 1995. Niger is one of the African countries where the collection of government revenue is at the lowest level. I fully concur with the central objective of the program to increase the share of budgetary revenue to GDP from 6 percent in 1994 to more than 10 percent in 1997. I am comforted to see that the performance in 1995 has been quite strong, with an increase of 1.2 percent of GDP.

Finally, the decision to cut wages by 33 percent is not negligible. The peaceful reaction to this decision shows that the capacity of the authorities to implement tough policy should not be underestimated. We are well aware of the still very difficult situation, but we think that we should acknowledge some significant progresses which are under way.

Two interesting issues related to the timing of the discussion have been raised by previous speakers. I think we should call a spade a spade and address directly the real underlying issue of how far the Fund can go regarding political conditionality. I think we have a way to handle this issue very smoothly, which is that which has been followed, i.e., to leave political conditionality to bilaterals. Indeed, that is what they have done.

Bilaterals have set criteria for political conditionality. Of course, those who have done so were those who were ready to consider providing bilateral support. There is a difficulty in that, when a country is not involved in the provision of financial assurances, it is not part of this process of political conditionality—at least, not directly. I think that when bilaterals, be they countries or the European Union, have indicated that they consider that the political conditions are met for the resumption of their structural adjustment support, the Fund is right to take their word for granted and not second guess their judgment.

The second issue is: should we consider approving programs in the run-up to elections or should we wait for the result of elections? I ask the question on general grounds, because we cannot have different policies concerning different countries, whether one is big or small, influential or not. In this regard, I think our experience has shown that our capacity to move early enough and to provide support, as long as the government has agreed on a clear set of objectives and has taken the prior actions, is decisive in helping the government to sustain its own commitments. Experience in many African countries has shown us that we run the risk of losing the opportunity to support a country, if we wait until all uncertainties disappear.

The Chairman said that the management had carefully considered its decision to recommend the ESAF program for Niger. As a rule, the Fund did not impose political conditionality on its members. While it was not for management to judge the quality of Niger's timetable for a return to democracy, management had noted that key bilateral donors and other multilateral institutions had resumed their assistance to Niger. In the area of economic policy, the authorities had taken courageous steps, including a 33 percent reduction in the real wages of public sector employees. Management thought it important to extend support for the ESAF program as rapidly as possible in order to help solidify the hitherto fragile normalization process.

The staff representative from the African Department noted that performance in 1994 had not been encouraging. When the government came to power in early 1995, the staff had indicated that the authorities would need to have a track record before an ESAF-supported program could be implemented. The 1995 performance, under the informal program developed by the authorities with the assistance of the staff, had been encouraging. Tax revenue collection had improved, and the wage bill had been contained. On that basis, the staff, in cooperation with the World Bank and the authorities, had developed a program that could be supported by an ESAF arrangement. The process had been interrupted in early 1996 when donors had withdrawn financial support, thereby creating a financing gap. At the present time, there were clear indications that the necessary financing would be forthcoming and, therefore, the staff could recommend proceeding with the program.

Regarding year-to-date performance so far in 1996, the staff representative indicated that a CFAF 1 billion shortfall in revenue had occurred in the first quarter. However, the data for April was encouraging. At CFAF 7.8 billion, it was effectively CFAF 1 billion more than expected. Several additional measures had been taken by the authorities, including the census on the size of the civil service and the enactment of the privatization law. Technical assistance provided by the staff included the development of mechanisms for monitoring and implementing macroeconomic and budgetary policies at several committees at the Ministry of Finance, the Treasury, and an interministerial committee. Besides timely data gathering, the new mechanism would allow the authorities to detect any performance slippages and propose corrective actions on a timely basis. Niger had also been receiving technical assistance in the areas of customs and tax administration. The World Bank had a resident mission in the country, providing assistance in such key structural areas as parastatal reform, social services reform, and the energy sector reform.

Inclusion of commercial debt would have little impact on the conclusions of the long-term debt sustainability analysis, the staff representative continued. The commercial loans extended to mining companies were expected to be repaid by 1999.

The reduction of 2,000 in the number of public service employees was equivalent to 5 percent of the total public service employment, representing a significant reduction in the case of a country with poor social indicators such as Niger, the staff representative noted.

Turning to investment and saving, the staff representative indicated that, provided fiscal policy was implemented according to the program, then public saving would increase to the intended levels. The introduction of new commercial laws and labor laws combined with a more stable environment, and underpinned by support from the international community, should play a key role in improving prospects for private sector investment. The privatization program envisaged privatization of three enterprises: a cement company, a slaughterhouse, and a hotel. The intention was not merely to reduce the government's equity participation to less than 50 percent, but to eliminate the government's share altogether, and transfer management to the private sector. Over the medium term, additional enterprises would be privatized.

Mr. Esdar made the following statement:

> I can agree with the staff's policy recommendation. The stabilization program goes in the right direction and addresses the main problem areas. Therefore, while sharing the concerns of Mr. Newman and Mr. Grilli with regard to the timing of this decision, we can go along with the proposed ESAF arrangement.
>
> Details of the program have been discussed by the lead speakers, and the crucial areas have been addressed. Like Mr. Kiekens, Mr. Newman, and

Mr. Grilli, we would urge the authorities to place special emphasis on the process of budget consolidation, both on the revenue as well as on the expenditure side, and on accelerating the pace of structural reforms of the agricultural sector, the labor market, and especially the civil service reform. In this regard, I noted with interest that six of the seven structural benchmarks or performance criteria under the first annual arrangement are set for mid- or end-June. I wonder whether the staff could give us some more information about the progress in those areas, as we have come already very close to these dates.

However, as Mr. Newman has already reminded us, there is no doubt that the financial involvement of the Fund in Niger at this time poses severe risk. The very fragile political situation in the pre-election environment raises considerable doubt whether the government will be in a position to fully implement the program as agreed. The disappointing track record under former programs reinforces such doubts.

The ongoing financial support of bilateral donors as a precondition for the financing assurance of the program critically depends on the continuation of the process of political stabilization and democratization. Given these risks, we would have preferred to backload disbursements under the first annual arrangement to better reflect progress in the implementation of the program. This would have limited, at the same time, the financial risks for the Fund.

However, in general, we would like to stress that our support is based on the strong expectation that the process of political stabilization will not deviate from the agreed timetable, and that the program will be implemented in all its elements. We expect that, if deviations should occur, the authorities will react immediately to keep the program on track.

Mr. Himani made the following statement:

Owing to the events since 1994, Niger has lost precious time in understanding the necessary measures to realize the benefits of the CFA franc devaluation. It is, therefore, heartening to see that the authorities are now in a position to embark on this much needed program.

The staff notes that "while not overly ambitious in its macroeconomic objectives, the program will impose a burden on Niger's administrative and implementation capacity . . ." Indeed, the program before us entails a wide range of measures that will stretch the authorities' capacity. Thus, I would prefer to characterize this program as being as ambitious as circumstances seem to allow. Clearly, further strengthening of the program can and should be undertaken as implementation capacity is strengthened. To this end, appropriate technical assistance is critical.

While the program entails a number of risks, I am reassured by the authorities' demonstrated commitment. This has been most recently manifested by the bold policies implemented since developments in January.

I support the proposed decision and wish the authorities every success.

Mr. Duenwald made the following statement:

Developments in the Nigerien economy have been closely correlated with the fortunes of the world market for uranium. The latter's collapse in the mid-1980s was followed by a decline, averaging 2.2 percent per year during 1985–95, in real GDP per capita, making Niger one of the poorest countries in Africa. The former government, elected in February 1995, had made some progress in improving budgetary performance and in reducing macroeconomic imbalances. While political factors have undermined performance thus far this year, the new government has demonstrated a willingness to take tough measures in order to keep the program on track. However, the achievements to date represent first steps in a long journey, and Fund financial assistance, in addition to other multilateral and bilateral assistance, will play an important part in helping the authorities tackle the daunting challenges that lie ahead. Therefore, and in consideration of Niger's good recent track record in economic policy performance, we support the proposed decision.

I will be brief, as the staff has been thorough in its analysis, and prudent in its recommendations. Given Niger's participation in the West African Economic and Monetary Union, the main lever of macroeconomic policy at the authorities' disposal is fiscal policy, as Mr. Grilli noted, Niger's adjustment program appropriately focuses on measures to tighten the fiscal stance. The weakened fiscal performance in the first quarter of this year, related to the military coup and subsequent developments, has made fiscal rectitude even more critical. More generally, the disruptions earlier this year have had significant implications for the program negotiated by the former government, namely a wider-than-originally-programmed financing gap which necessitated additional measures. The new government has adopted these measures and appears to have embraced the program. However, we stress that full implementation of the current timetable for a return to democracy is urgently needed to ensure full donor financial assistance, the resumption of which, as Mr. Koissy notes, will significantly influence the success of the program. In this regard, we welcome the steps already taken by the new government in returning Niger to democratic rule, including a referendum on the new constitution and the lifting of the ban on political parties.

Before closing, let me say a few words about Niger's external public debt situation. Niger is a heavily indebted low-income country, and the staff's analysis in the background paper suggests that Niger's external public debt, much of which is owed to multilateral creditors, is borderline sustainable, but stressed. The sensitivity analysis shows the fragility of Niger's external debt situation and reinforces the need for the authorities to implement fully the adjustment program. Once Niger has established a track record of good performance under the ESAF-supported program, an assessment could be made in the future whether the country might be eligible for treatment under the HIPC debt initiative.

Mr. Issaev made the following statement:

Niger has experienced tremendous difficulties over the past years, and we regret that the January 1996 events have further deteriorated the economic situation and widened the financing gap. As the staff paper indicates, the authorities recognize all measures that need to be implemented and are taking the bold adjustment steps. We commend the determined efforts of the government to address macroeconomic imbalances and structural rigidities and believe that their reform program deserves the support of the Fund.

As we agree with the thrust of the staff appraisal, I will limit my comments to a few points.

Niger's fiscal situation remains weak. Therefore, in the fiscal area, the main challenge for the authorities is to increase budgetary revenues. It is welcome news that in early 1996 the authorities have introduced a number of revenue enhancing measures and taken steps to strengthen tax and customs administration. However, we were disappointed to know from the staff report that these measures are not fully effective and revenue performance in the second quarter is likely to remain weaker than originally expected. In this regard, we wonder whether the 1996 target to raise budgetary revenue to 8.2 percent of GDP is realistic.

We welcome the wage agreement recently reached with the labor union and commend the government for taking the decision to reduce the civil service wage bill by one-third in 1996 to offset lower than planned revenues. However, in a view of the forthcoming presidential and parliamentary elections, this decision seems to be very ambitious.

Niger's social indicators clearly show that there is an urgent need for redirecting spending priorities toward social services. We urge the authorities to take a more efficient approach to social safety net and poverty alleviation, and to speed up structural reforms.

With a weak fiscal performance, Niger has accumulated a huge amount of domestic and external payments arrears. Therefore, addressing arrears should be a priority for the Nigerien authorities. It is an encouraging sign that domestic payments arrears accumulated in late 1995 were cleared through the issuance of Treasury bonds, and that the government intends to settle most of the outstanding domestic arrears in the same way. Meanwhile, the stock of external arrears will be eliminated in the next year, and nonaccumulation of external arrears is a performance criterion under the ESAF program.

Given Niger's extremely large external imbalances and the limited capacity for debt service, the risk for the Fund in lending to Niger is high. Additional external assistance under concessional terms and debt relief will be needed over the coming years. In this connection, we encourage the authorities to take all required steps to normalize their relations with external creditors. We were pleased to know that major donors have given the indication to resume their financial assistance to Niger in conjunction with the ESAF-supported program, and the country is seen as a potential candidate for the new debt relief plan. However, it seems clear that this assistance will be fully forthcoming only if the authorities continue to demonstrate the return to democracy.

With these remarks we support the proposed decisions.

Mr. Munthali made the following statement:

The emergency program which the Nigerien authorities initiated in 1995 was a good beginning in reversing the economic decline that characterized the last decade as Mr. Koissy has reiterated in his informative statement. The previous government built upon the success of that program to formulate a medium-term economic adjustment program for which Fund assistance was being sought under the Enhanced Structural Adjustment Facility. The important progress that was being made in reducing the macroeconomic imbalances regrettably came to a sudden halt because of the political events of January this year. However, we are encouraged that, although the financing gap widened, the new government was quick to realize the gravity of the problem and took prompt action by implementing additional measures. To ensure the financing of the program, the government secured donor support by, among others, assuring a quick return to democratic polity and adopting a strict timetable toward that end.

The new government realizes that Niger faces a very difficult economic and financial situation, characterized by the severe macroeconomic imbalances and widespread poverty. This will require tough political choices for continued economic adjustment in order to attain sustainable growth in the medium term. The measures contained in the program as strengthened by the recent additional policy action, taken in the aftermath of the coup, represent yet another good beginning that deserves the support of the Fund. This chair believes that Niger's adjustment effort needs to be anchored by an arrangement with the Fund at an early stage.

In particular, we find the Fund's support under the ESAF to be suitable for the Nigerien situation because of the country's heavy external debt burden. In that connection, two aspects regarding the external debt situation are somewhat troubling. First, the debt sustainability analysis shows that the reduction in debt servicing outlays to a sustainable level will be slow to achieve in part because past rescheduling arrangements and the recent accumulation of arrears. Besides, a significant proportion of its debt is owed to multilateral institutions such that only a certain percentage is subject for restructuring. Second, the analysis also demonstrates serious downside risks associated with the prospective level of grants and uranium exports. Both of these are uncertain, especially with uranium experiencing a secular decline in prices. This reinforces the need for sustained efforts for economic adjustment.

Let me say parenthetically that the competitiveness exercise included in the background paper was quite revealing as regards the degree of integration of the Nigerien economy with that of neighboring Nigeria in the south, albeit on an informal basis.

As emphasized by the staff, caution should be exercised in using these findings not only because of the informal nature of cross border trade but also because of inherent deficiencies in data, especially in price movements. This data problem is prevalent on both sides of the border and could exacerbate the analytical distortions.

There is no doubt that the success of the program will depend on the rapid restoration of fiscal discipline. With revenue being a comparatively small proportion of GDP, even by regional standards, the emphasis on strengthening performance through improvements in tax administration and the minimization of fraud in customs, is an important step in the right direction. On the expenditure side, while we realize the need to reduce the wage bill in relation to GDP, absolute cuts in salaries to compress the wage bill in a volatile political environment could be a source of concern. I wondei whether or not other feasible options were considered by the authorities; I would appreciate any comments from the staff. Nevertheless, its implementation serves to demonstrate the determination of the authorities to take strong action whenever deemed necessary for which they deserve to be commended.

The strengthening and reform of the banking system would be important in supporting the prudent monetary and credit policy which has been formulated at the regional level, consistent with the need to maintain price stability. In that connection, the recapitalization of the BCN and the auditing of the country's main nonbank financial institutions as a first step toward the restructuring of the financial sector, should be expedited.

Finally, in a situation of widespread poverty, safety net provisions should formulated in the context of the overall development strategy, spelling out clearly specific programs to address this enormous problem. Hence, the provision of social services like preventive health care and the provision of primary education in developing human capital should be complimented by efforts to improve the productivity of the agricultural sector on which the majority of the rural population depend.

In sum, we are in broad agreement with the staff appraisal and we can support the proposed decision

Mr. Mori made the following statement:

We are in agreement with the policy recommendations contained in the staff papers and sympathize with the difficult circumstances being experienced by Niger. In view of the Nigerien authorities' commitment to implement the economic and financial adjustment program, and considering that the program is adequate for beginning to address the macroeconomic imbalances, structural rigidities, and weak social indicators that beset Niger, we support the proposed decision.

Mr. Hammoudi made the following statement:

The problems of the country are severe and we are not surprised by social and political tensions as the economy has shrunk by one fifth owing to a prolonged and continuous decline in the international price of uranium, the only source of revenue for Niger. In addition, the currency devaluation—in the absence of exports other than uranium—has hit the population badly through its immediate and sizable impact of domestic prices. In this situation, an adjustment program containing macroeconomic and structural measures as requested in the paper before us today is needed, but with the full support of the international financial institutions and the donor community if success in implementing the program is to be achieved. This support is warranted as the new authorities are committed to carrying out reforms.

The government's main task is to overhaul the tax and customs system with the aim of broadening the tax base and simplifying procedures in order to boost revenues. In the expenditure area, it is essential to reform the civil service while providing financing for the long-ignored social sectors, especially given the difficult and tense social situation. Indeed, foreign assistance, we believe, is badly needed since government revenues are insufficient to fund such services.

The other difficult task is to restructure the economy in order to diversify it and to generate other sources of revenues since the outlook for uranium exports is not very bright. In this respect, promotion of private sector privatization and deregulation are the most important reforms that the government should focus on in order to develop light industries, services, and agriculture.

Finally, Niger needs a comprehensive debt relief from the Paris Club and private creditors given the difficult financial situation and the balance of payments outlook. Multilateral institutions should also be involved since two thirds of Niger's external debt is owed to those institutions, with 40 percent of debt service also due to these institutions.

With these comments, we support the proposed decision, and wish the authorities well in their adjustment efforts.

Ms. Daguston made the following statement:

We support this ESAF program. Obviously, as a number of colleagues have noted, the financing is vulnerable to a number of political factors. But we were pleased to see the useful contingency measures built into the program by the staff. Those measures will make the program manageable. Concerning Niger's debt situation—when Niger has built up a good track record of reform, we might need to return to this country and examine its debt situation in order to determine whether it should benefit from some extraordinary measures under the proposed HIPC debt initiative.

Mr. Galicia made the following statement:

I will be very brief. Since we concur with the staff's analysis, we endorse the policy recommendations made by the staff and support the proposed decision.

We sympathize with the difficult circumstances faced by the people of Niger. Nevertheless, we support Mr. Newman's recommendations that progress toward economic stability in the country is absolutely necessary to maintain Niger's development in the right direction. We also agree that the commitment to the democratic process needs to be emphasized to the authorities in the next visit of the Deputy Managing Director to Niger.

We trust the authority's efforts to maintain the program's policies , and wish them well in their endeavors.

Mr. Tahara made the following statement:

It is encouraging that the new government has declared its commitment to structural adjustment and adopted the program negotiated by the former government. The government's prompt decision to reduce the wage bill of the civil service by one-third in 1996 is particularly commendable. Since Niger has to rely on a large amount of external assistance, it is crucially important for the authorities to strengthen the credibility of their policy commitment among the donor community by keeping the economic program on track.

Clearly the most urgent challenge for the authorities is institution building, particularly in the areas of tax administration, civil service reform, and the legal environment for private sector activity. In this respect, I hope that Fund technical assistance, in particular from the Fiscal Affairs Department's technical assistance missions, will be used effectively by the authorities. The disbursement of CFAF 40 billion from major donors is crucial to fill the remaining balance of payments gap. But since the resumption of donor assistance depends on the authorities' strict implementation of the timetable for a rapid return to democracy, I hope this condition will be fully observed.

Finally, let me comment briefly on the debt sustainability analysis. The results indicate that Niger's debt situation is broadly sustainable but stressed. Real GDP and export growth at the same or more favorable level than assumed in the baseline scenario can be attained only through sound macroeconomic policy, which in turn will enable a substantial increase in the saving rate through improvement of the fiscal balance.

With these remarks, I support the proposed decision and wish the authorities every success.

Mr. Saito made the following statement:

> I will be very brief. Let me just mention that, despite the current difficult circumstances faced by the country, I welcome the fact that the authorities of Niger have moved quickly to declare their commitment to the structural adjustment and also have embraced the program negotiated by the former government. I also welcome the accelerated timetable for the return to democracy and the steps in that direction already taken. Furthermore, I share the staff's view that, to ensure continuity in policy implementation, there is an urgent need to reinforce the consensus in support of Niger's adjustment effort. Thus I support the proposed decision.

The staff representative from the African Department said that the two structural performance criteria—the value-added tax on imports and the establishment of the privatization commission—slated for implementation by end-June—were on schedule.

Mr. Koissy made the following concluding statement:

> Allow me to thank the Directors for their comments and support of Niger's request for an ESAF, and the staff for the answers on Niger's situation.
>
> There is no doubt that Niger's economic and financial situation is difficult. My authorities do not underestimate the task ahead of them, and they understand that success will depend on a steadfast implementation of the policy measures envisaged. However, I would like to note again that this success will also depend as much on external financial assistance. Niger's need for development assistance is great, and the authorities are hoping that this program will help to catalyze financial resources, and also free other resources that have already been promised. Moreover, Niger's external debt acts as a severe drain on the economy, and a solution to the debt problem will also do much to free resources which can be used to improve the economy and the living conditions of the people.
>
> Some concerns were raised regarding the political process. On this point, I would like to stress that my authorities have taken concrete actions. For instance, they have lifted the ban on political parties, called off the state of emergency, and brought forward the election date. Despite changes in government, the commitment of the Nigerien authorities to the adjustment process has not wavered, as can be seen from the list of actions taken last year and also since the beginning of this year by different governments.
>
> Also, I fully share the views expressed by Mr. Autheman regarding political conditionality and the need to have uniformity of treatment. If the authorities are abiding by the agreement of the program, it should be approved on its merits. Such approval will certainly accelerate the momentum of adjustment and strengthen the authorities' determination to take the difficult but necessary measures that are required. This program will also help foster political consensus.

I have noted the concerns of Directors regarding the need for strengthening the revenue base and also of tax administration. Much has been done in these areas, but this can be improved further. My authorities intend to continue their efforts in this direction so as to ensure a stable stream of revenue for the government. The issues of the wage bill and of the civil service are being addressed. My authorities share the view that the wage bill has to be reduced by much more so as to free resources for other pressing needs, and they intend to continue their efforts in that direction.

Finally, let me reiterate my thanks to Directors for their support and to assure them that I will convey their comments to my authorities in Niger.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They observed that despite the adoption of several adjustment programs over the past decade, economic performance had been weak and Niger's policy track record had been poor. Directors welcomed the authorities' renewed commitment to structural adjustment, as reflected in their recent decision to press ahead with the medium-term reform program to be supported by an ESAF arrangement. They noted that a number of positive results had already been attained, particularly with respect to reducing inflation and restoring some order to public finances. Directors stressed that strict implementation of the program was essential to lay the basis for private sector-led growth, reduce poverty, and restore donors' confidence, noting that the success of the program critically depended also on the authorities' progress in carrying forward the democratization process.

Directors emphasized the importance of a continued and determined strengthening of government finances. Noting Niger's very low tax-to-GDP ratio, they encouraged the authorities to step up revenue mobilization by further expanding the tax base and improving tax administration; they hoped that the cessation of political turmoil would facilitate these efforts. Directors commended the authorities for the courageous wage reduction effected in 1996. They underscored the need for steps to ensure that, over the medium term, the government wage bill did not crowd out other current expenditures that were needed to meet basic needs. To that effect, Directors called for a timely completion of the civil service reform, including the retrenchment program and the introduction of a merit-based pay system. At the same time, they stressed the need to maintain an adequate level of priority spending for education, health, and maintenance, which was essential to begin addressing Niger's extremely weak social indicators.

With regard to structural measures, Directors noted the importance of strict adherence to the timetable for the implementation of the reform program, particularly concerning privatization and parastatal restructuring, banking system reform, and liberalization of the labor market. Technical assistance was needed to help improve implementation capacity.

Directors observed that Niger's balance of payments and its external debt service remained fragile and vulnerable to external shocks, underscoring the need to effectively implement the medium-term program. They also urged the authorities to clear all external payment arrears and to pursue a prudent external debt policy that relied primarily on grants and on highly concessional loans.

Directors also noted Niger's acceptance of the obligations under Article VIII.

It is expected that the next Article IV consultation with Niger will be held on the standard 12-month cycle.

The Executive Board took the following decision:

1. The government of Niger has requested a three-year arrangement under the Enhanced Structural Adjustment Facility, and the first annual arrangement thereunder.

2. The Fund notes the policy framework paper for Niger set forth in EBD/96/9.

3. The Fund approves the arrangements set forth in EBS/96/10, Supplement 2.

Decision No. 11274-(96/56), adopted
June 12, 1996

4. ERITREA—1996 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1996 Article IV consultation with Eritrea (SM/96/120, 5/21/96). They also had before them a paper on recent economic developments in Eritrea (SM/96/122, 5/29/96).

Mrs. Guti, speaking on behalf of Mr. Dlamini, made the following statement:

The Eritrean authorities have benefited from the policy dialogue with the staff in connection with the 1996 Article IV consultation. Fund technical assistance also continues to play a critical role in helping to strengthen Eritrea's administrative capacity and improve the country's statistical data base. My authorities agree with the general policy thrust of the staff report, which, to a large extent, is based on policy measures that are already being implemented as part of their development program.

Eritrea is one of the special cases among developing countries. Apart from the vulnerability of being a small and undiversified economy, there are also the daunting challenges of building a modern nation state from scratch, with meager resources, after a prolonged war that left the social and economic infrastructure in disarray. Eritrea is also an economy in transition, facing the problems endemic to such economies that are in the process of replacing central planning with a market-oriented policy thrust, geared toward making the private sector the primary engine of growth. Under the circumstances, the authorities have had to pursue a broad-based development strategy in order to lay a solid foundation for future growth within a stable macroeconomic environment. This framework necessitates a long-range perspective.

Under their "home-grown" development strategy, significant progress has been made on several fronts. Steps have been taken to improve the climate for private investment, and rehabilitation of economic and social infrastructure has been accorded the highest priority. The authorities' commitment to economic liberalization is also being felt throughout the economy with the deregulation of economic activity, including the lifting of most price controls and the steady liberalization of the trade and exchange system. Export taxes were removed, tax administration strengthened and the rates have been rationalized, one of the goals being to encourage investment. A new investment code is now in place and an agency to manage the privatization of public enterprises has been established. The development effort has also been extended to the civil service, which had been cut by a third by the end of 1995, and administrative regions reduced from 10 to 6. Meanwhile, the army has been reduced by 48,000.

The response of the economy to all these measures has been quite positive. Average real output growth for 1993–95 outpaced population growth; inflation remained relatively low; exports have been buoyant and the revenue base continues to broaden. There has also been a surge in the interest of private investors, particularly in the manufacturing sector whose relative share in the economy has grown from 19 percent of GDP to about 25 percent during 1992–95.

However, the fiscal situation came under pressure in 1995. The deficit widened and was financed, for the most part, by borrowing from the banking system. Although there was a significant increase in revenue, expenditure was high due to a number of special outlays including: severance payments for government employees; compensation to war victims; demobilization and reintegration of ex-combatants to civilian life; rehabilitation of displaced persons; and retroactive wage payments backdated to January 1994. These were one-off payments, regarded by the authorities as necessary to forge and strengthen the social consensus that is critical for political stability and economic development in Eritrea. Also, the level of the deficit in 1995 was influenced by food relief efforts, given the bad harvest.

My authorities are optimistic about the medium-term budgetary outlook and are taking the necessary measures to strengthen public finances, being aware of the potential for macroeconomic instability which is associated with high budget deficits. The finalization of the civil service rationalization, a trimmed army and fewer administrative regions are expected to bring about savings in the long run. The repatriation of refugees will be undertaken with the assistance of the United Nations. In addition, a decision was taken in January 1996 to monetize all food aid and the proceeds will be earmarked for targeted social safety nets and development expenditures. On revenues, the authorities are keen to improve revenue buoyancy. They intend to continue rationalizing the tax and tariff systems and improve the administration of collections and they will continue to seek Fund technical assistance in this area. Public enterprises, which have already paid substantial dividends, are expected to improve their performance as most of them have been recapitalized, their equipment refurbished and managerial efficiency improved. The authorities are also taking measures to accelerate the privatization process. These measures will contribute to budgetary consolidation. It is to be noted that high priority is being accorded to the formulation of a comprehensive national budget with great importance being attached to the prioritization of expenditures, particularly with regard to public sector investment projects.

The authorities are aware that forging ahead with structural measures is critical if Eritrea is to sustain a high rate of economic growth. In this regard, port facilities will be modernized and managed as independent authorities. The legal framework established in support of the private sector will be enforced and competition will be enhanced in all sectors of the economy.

Inflationary pressures in 1995, for the most part, reflected a poor harvest as a result of unfavorable weather conditions and locust infestation. Nevertheless, the authorities feel that inflation in Eritrea, as measured by the Asmara commodity price index, does not incorporate many products whose prices have generally come down due to improved supply under a more liberal trade regime. Also, the index does not include services, whose prices have shown a stagnation or a downward trend. Moreover, monetary growth has been decelerating, from a peak of 140 percent in 1992 to about 23.5 percent in 1995.

The authorities are of the view that the introduction of their own currency would give them independence in monetary policy management. They are also aware that rushed decisions in this area will be counterproductive. In this regard, all the necessary preparations for the introduction of their own currency are being taken and are at an advanced stage. These include the formation of a central bank and introduction of a new legal framework for the financial sector. The new central bank will enjoy a high degree of independence and would be empowered with the supervisory and prudential role of the financial system, including the licensing of both domestic and foreign banks. It will introduce market-based instruments of monetary policy management which will allow the government to finance its investment requirements in a non-inflationary manner. With the financial sector policy measures so far implemented, confidence in the banking system has improved and deposits are rising at a fast rate.

My authorities appreciate the immediate benefits for macroeconomic management that accrue from an improved statistical data base. They have established a central statistical office which is being strengthened with a view to compiling national accounts and other vital economic statistics. The authorities are currently conducting household expenditure and other surveys aimed at compiling comprehensive consumer price indices that would allow them to closely monitor inflationary and other economic developments. They will continue to count on technical assistance from the Fund and other organizations in this area.

It is important to note that Eritrea maintains no quantitative restrictions on trade. The tariff system reflects the priority given to the importation of capital goods and intermediate inputs. On the foreign exchange system, the allocation system gives priority to productive investment. However, the Bank of Eritrea authorizes all bona fide payments and transfers on international transactions. Transactions outside the banking system are accommodated at the more deprecated rate. The authorities took further steps in 1995 to liberalize the foreign exchange regime. Residents were allowed to maintain foreign currency denominated accounts, payments restrictions on invisibles were eased significantly, documentary requirements for importers, foreign exchange dealers and travelers were eased and restrictions on purchase of airline tickets were also removed.

The authorities are aware of the potential risks associated with huge import requirements in the period ahead. They are taking measures to promote exports with a view to maintaining a sustainable balance of payments position. In this regard, the exploitation of fisheries is beginning to be resuscitated on a large scale. Under the new investment code, the response of foreign investors to the opportunities for exploration and exploitation of a number of minerals, including gold, is overwhelming. Exports of manufactured goods are also expected to pick up markedly as investment in that area is growing at a fast rate. Moreover, the authorities will continue to pursue reforms in the trade and exchange systems with a view to removing remaining restrictions. The authorities are also wary of incurring a high external debt burden and will continue to proceed with extreme caution in this area. It is very important to add, however, that adequate and timely concessional financial assistance from the international community, consistent with the priorities of the authorities, is essential to putting Eritrea on a sustained path of economic development. Such assistance would also play a critical role from the start of helping to steer the country away from the debt trap, thereby improving its prospects for external viability in the long run.

Mr. Grilli made the following statement:

Since last year's Article IV consultation, the first after the country became a member of the Fund, remarkable progress has been made in the areas of reconstruction and rehabilitation of the economy. While the country showed strong signs of recovery, the government has acted consistently with its main objectives of promoting high and sustainable growth and increasing per-capita income. It has introduced wide range reforms in a number of critical areas, most notably deregulation of private business activity and investment promotion, tax policy, administration and civil service. Nonetheless, the economic and political challenges that Eritrea faces remain large. Structural reforms to expand the country's productive and export potential in the long run are obviously indispensable, but a careful management of fiscal and monetary policies in the short and medium terms is equally important to pave the way to sustainable growth and raise the standards of living permanently.

The deterioration in the public finances observed in recent years is a source of concern. This pattern has continued during 1995, when the fiscal deficit, including grants, has more than doubled as a percentage of GDP, from 8.0 to 17.5 percent. While small fiscal deficits would not be a reason for major concern, and could be even justified in terms of the country's great need of infrastructure, deficits of the sizes being experienced now are clearly unsustainable in the long-term. They are also inconsistent in the long run with the government's goal to foster private activity, insofar as they restrict credit availability to private enterprises and tend to increase the size of the public sector.

I note that, in 1995, tax revenues increased significantly (9 percent), and that public capital expenditure increased by 16 percent, compared with a 37 percent growth rate in current expenditure. It is, thus, evident that current expenditure growth is excessive, much above what the country can afford given its current revenue capacity and too skewed toward consumption, to the detriment of badly needed capital outlays. There is an urgent need, therefore, to pursue a strong consolidation effort and a rebalancing of public sector expenditure. To achieve a better fiscal balance, the Eritrean government should act both in the direction of a further enlargement of the tax base and of containing the dynamics of current expenditures. The implementation of more efficient resource management procedures, especially through a systematic prioritization of investment projects, would prove useful in containing the rise of public spending. In this area, what comes to mind can be done by the Fund together with the World Bank.

Concerning monetary policy, the government's intention to establish a national currency is understandable, as a final step toward economic independence from Ethiopia, and it is perhaps in the country's best interest. To achieve this objective, however, the right economic conditions must be in place. These involve not simply better fiscal fundamentals, but also a central bank able to manage independent monetary and exchange rate policies. In the meanwhile, the scope of monetary policy will remain limited by the de facto monetary arrangement with Ethiopia. It is, therefore, crucial that, while progress continues toward building the capacities necessary to the Bank of Eritrea to exercise its role effectively, monetary policy coordination with Ethiopia be continued.

The central bank's authority to set interest rates and channel credit flows, the only instruments available at the moment, must be exercised carefully. One can agree that, under the present conditions, monetary policy should primarily aim at (1) directing credit, and lowering its cost, to strategic sectors of the economy, (2) fostering the accumulation of domestic saving and, (3) limiting excessive inflows and outflows of capital, especially with Ethiopia. However, it is essential that this does not result in too much financial repression and that the direct credit allocation function be phased out as soon as possible. Financial markets should allocate credit, not the monetary authority by fiat.

Some elements, however, already point to the existence of financial repression in the Eritrean economy. I note, in particular, that interest rates are negative in real terms, as the average nominal rate on short-term deposits (6–8 percent) is significantly below the inflation rate (11 percent). It is clearly arduous to stimulate the accumulation of domestic saving under these circumstances. Another complication is due to the fact that interest rates in Eritrea are significantly lower than those applied in Ethiopia, thereby stimulating short-term capital outflows. As interest rates applied on loans are also negative in real terms, higher interest rates would reduce the above mentioned problems without hindering the growth of investment. This suggests that greater flexibility is, indeed, required in the determination of interest rates in Eritrea. I would appreciate the staff's comments on these points.

Concerning the external sector, the government should not overlook the significant widening of the trade deficit since 1993, a pattern which is suggestive of a correlation with the worsening of the public finances. Export competitiveness is crucial for Eritrea's growth prospects. However, the tendency of the real effective exchange rate to appreciate since 1993, which is clearly shown in Chart 2 (p. 18), suggests a gradual loss in the country's export competitiveness. A second disturbing aspect is the poor geographical diversification of exports, which are still in most part (66 percent) dependent on the Ethiopian market, a pattern which has strengthened in 1995. The need to promote exports, by increasing their competitiveness and geographical diversification, is evident, and it is also necessary to reduce Eritrea's dependence on economic developments in Ethiopia.

Turning to structural policies, remarkable progress has been made on several fronts, but the government should intensify its efforts in some key areas. Besides the financial sector, on which I already commented before, the area of privatization is critical the government has reiterated its commitment to sell most state-owned enterprises, but not much has been achieved in practice, including the development of a fully specified disinvestiture program. A major effort should also be directed toward the improvement of the national statistical system. The poor quality of the data stands out as a major difficulty in the monitoring of the economic situation in Eritrea.

With these remarks, I support the proposed decisions.

Mr. Al-Turki made the following statement:

Eritrea has made significant economic gains since independence in 1993. Per capita income has grown markedly in real terms due in large part to a substantial increase in industrial production. These gains reflected a restoration of relative economic stability after decades of dislocations from war and natural disasters. The economy also benefited from the authorities' focus on economic rehabilitation and reform of the economic, legal, and institutional framework for market-led growth.

The challenge the authorities are faced with is to build on past progress to set the stage for sustained growth. It is, therefore, unfortunate that there are signs of a slackening of the adjustment effort. For continued economic recovery, early action is clearly essential to counteract the year's inflation upsurge, fiscal deterioration, and weakening of the external payments outlook.

On the macroeconomic front, the staff has rightly emphasized the paramount need for a major fiscal consolidation effort. There is no denying that expenditure containment will remain difficult in an economy still faced with a major post-war rehabilitation and refugee reintegration task. It is encouraging to note that the authorities are cognizant of the challenge and determined to both prioritize spending and take steps to increase revenues. In this connection, the authorities are encouraged to press ahead with their plans to further broaden the tax base and strengthen the tax and custom administration.

I welcome the authorities' careful approach to launching of a national currency to replace the de facto currency union with Ethiopia. In that regard, a strong fiscal consolidation effort and a supportive monetary policy stance are essential since a reputation for financial prudence is critical for confidence in the new national currency. Also needed on a priority basis is a suitable legal framework and institutional capacity for normal functioning of the central bank and other financial institutions.

On structural reforms, I am encouraged by the restructuring of the civil service which included a significant cut in the number of employees. The same bold approach should now be extended to eliminate the remaining price controls and to speed up privatization of the state-owned enterprises. Fund's technical assistance and policy advice for Eritrea in these areas would be very useful. I also welcome the prospect that the Eritrean authorities may seek an arrangement under the Enhanced Structural Adjustment Facility.

With these remarks, I wish the authorities further success. I would also like to commend the staff for these well-written and informative reports.

Mr. Iradian made the following statement:

Eritrea has made significant progress in the past two years. Real per capita income increased, inflation, although recently rising, remained modest, and several structural reform measures were implemented. However, the external current account balance shifted to a sizable deficit, the overall fiscal deficit widened markedly, and domestic liquidity rose sharply. As I am in broad agreement with the staff's analysis, with the exception of the proposed sequencing of measures, I will limit my remarks to some of the challenges that face this new nation.

Like the staff, the focus of policy should, on a priority basis, be directed at institution-building, particularly in the fiscal and monetary areas.

Appropriate budget formulation and implementation mechanisms need to be put in place. This would underpin the major fiscal effort required of the authorities in the period ahead. Similarly, the management of monetary policy assumed added importance, particularly when a national currency to replace the birr, is being contemplated. This would require establishing an independent central bank with the necessary staffing and tools to carry out its functions. I strongly support the provision of technical assistance to address these two areas.

A major fiscal consolidation effort is needed to avoid domestic and external imbalances and to create an environment conducive to private sector recovery. Although the current high levels of expenditure may be necessary in a period of reconstruction and rehabilitation, budgetary discipline and prioritization of current and capital expenditure is needed within the context of a more comprehensive medium-term formulation of the government budget. While there are good reasons to assume that foreign assistance will continue at significant levels in the short term, the authorities must ensure that expenditures are consistent with available resources. It is clearly evident that the high level of budgetary deficits is not sustainable and will no doubt add to both the existing pressures on the balance of payments as well as on prices.

In view of the urgent need to address the budgetary situation, I am skeptical of the staff's advice on sharply reducing the maximum tariff rates from 200 percent to 50 percent at this time. Still on the budget, I note from the background paper that commercial banks are exempted from paying income tax. I wonder if it would not be appropriate to introduce a business profit tax on financial institutions. I am also interested in the staff's comments on the prospects of developing nonbank sources of domestic financing, such as treasury bills and other longer term securities.

In the monetary area, there has been limited harmonization of important macroeconomic policies between Eritrea and Ethiopia, despite the de facto currency union. Interest rate policies have been divergent, and exchange rate policies in Eritrea have been more liberal than in Ethiopia. In this regard, I encourage the Eritrean authorities to enhance monetary policy coordination with Ethiopia and to further tighten domestic credit policies. The latter actions would contribute to confidence in the new currency that could be introduced after strengthening the institutional capacity of the Bank of Eritrea to conduct independent monetary and exchange rate policies.

The introduction of a new currency is probably premature. This should await not only setting up the necessary institution but also improving the budgetary outlook.

The sustained implementation of structural reforms will be critical to improving growth and easing the constraints on the private sector's economic activities. I commend the authorities for introducing a liberal investment code, which I hope will stimulate private investment, including foreign direct investment. The recent reforms of the civil service are also important from the perspective of boosting public sector efficiency and savings.

With these remarks, I support the proposed decision and wish the authorities every success in their reconstruction and development efforts.

Mr. Loevinger made the following statement:

Despite the economic toll taken by a civil war, droughts, and a centrally planned economy, this chair had been optimistic about Eritrea when it emerged as an independent country. While Mrs. Guti noted the daunting challenges of building a modern nation from scratch, there were several advantages. It did not have a debt overhang. In fact it did not have any external debt. And it had a supportive donor community. Even more important, it had the advantage of being able to learn from the experiences of other African countries and avoid the pitfalls which retarded development elsewhere. Thus, despite their impressive achievements in opening their economy to trade and investment, it is disappointing that, particularly in fiscal and credit policies, the authorities appear intent on experiencing certain policy mistakes first hand.

After so many years of deprivation, there are understandably many pressing needs and many promises which have been made. Yet, the authorities must understand that their ability to meet these needs and fulfill these promises is limited by Eritrea's own productive capacity and the external assistance it receives. Eritrea will not be able to continue to consume in excess of these resources for very long. The authorities are trying to compensate too many people too quickly, and in the process, impairing their ability to achieve sustainable growth.

The current level of reserves (3.8 months) and grants from donors (15 percent of GDP) should not lull the authorities into a false sense of security. Both could dry up quickly. Official grants as a percentage of GDP have already fallen. After the war, Eritrea benefited from a reservoir of goodwill from donors. However, given the number of countries undertaking reforms, donor fatigue could set in quickly if economic policies do not improve.

Take away grants and the fiscal and current account deficits are 28 percent and 16 percent of GDP. Given the pressing investment needs, it is reasonable that Eritrea run modest fiscal and current account deficits. But deficits at these levels are simply not sustainable. Either the authorities can begin the adjustment process now, or adjustments much more difficult to control will take place. As the staff notes, if fiscal and credit policies are not tightened, the external position will become unsustainable. It would have been useful if they had illustrated in their medium-term scenario how soon this could occur.

It is also important to begin the adjustment now so that when the authorities introduce their own currency, they will have policies in place to maintain confidence in it. It seems to me that the adjustments required are too great for the authorities to take on their own, and we urge them and the staff to agree on a Fund-supported program at the earliest possible date. A Fund program would also help leverage concessional assistance which Mrs. Guti notes is critical for achieving sustainable development and external viability.

Adjustment will have to start with fiscal policy. Eritrea cannot continue to run such large bank financed deficits without either crowding out private sector investment or increasing inflation. In fact, based on available data, which is minimal, the latter appears to be already occurring. Furthermore, given that domestic credit growth continues to exceed nominal GDP growth, I think the staff is probably right that inflation has been underestimated. However, Mrs. Guti argues that inflation has been primarily due to supply factors, and has been overestimated. It would be useful if the staff could comment on his remarks.

It has been discouraging to see that every time steps are taken to boost revenues, expenditures increase even faster. We agree fully with the staff that limiting current spending must be one of the highest priorities. One way is to limit the civil service, and it is encouraging to see that the authorities have taken steps to do this. Another way is to stretch out compensation for families and ex-combatants. Authorities might also consider providing compensation in ways which support reform, such as through issuing privatization vouchers as has been done in several transition economies.

The authorities' ability to set spending priorities will remain impaired as long as they lack a comprehensive and coherent budget and budgetary procedures. Does the Fiscal Affairs Department currently plan to provide any assistance for this in the near term?

While the currency union with Ethiopia limits the authorities' ability to conduct an independent monetary policy, as the staff points out, there are many steps which need to be taken to promote stable policies and support a new currency. Freeing interest rates would both help boost domestic savings and limit credit growth. Lending rates to priority sectors are still negative. The central bank should also get out of the business of directing and lowering the cost of credit to priority sectors. It appears that the sector that has been receiving the most preferential interest rate is the government.

Finally, to allow the private sector to grow efficiently, cutting back the government's claim on resources, is not sufficient. The authorities will also need to reduce government control over and increase competition in the financial sector. In addition, there is a disturbing trend that received little attention in the staff report. As the government's involvement in financial and commercial activities recedes, its place is being taken up by firms owned and controlled by the ruling party. These firms raise many of the same problems as state-owned enterprises, namely that many of their decisions are not made on purely commercial grounds. Perhaps one of the most important lessons from the past 40 years, is that "party-led" growth has not been a particularly effective development strategy.

The staff representative from the African Department said that Eritrea's financial system was still quite rudimentary, with only one commercial bank and one housing loan bank functioning at the present time. In such circumstances, it would be difficult to consider market-determined interest rates, although the authorities were prepared to move in that direction as soon as feasible. The present low interest rates reflected the authorities' wish not to discourage investment, in light of the excess liquidity in the financial system. The staff supported the authorities' effort to introduce nonbank sources of finance, such as short-term and long-term securities.

The adverse impact of tariff reduction on revenue would not be significant, because the tariff rates in excess of 50 percent applied to only a limited number of commodities, the staff representative continued. An improved customs compliance and a higher volume of imports would be expected to offset any tariff rate reductions. The staff believed that significant improvements could be made in the areas of fiscal consolidation and, in particular, expenditure control. A coherent and comprehensive budget would be essential to accomplishing that objective.

As there was no official price index, the staff had been assessing inflation by using a commodity-based index, the staff representative indicated. It was likely that, because of the significant expansion in monetary growth in 1995 and the expansionary fiscal stimulus, the food-commodity price understated the current overall inflationary pressures in the economy.

Finally, on the issue of technical assistance, the authorities had taken advantage of a number of missions and short-term resident advisors, particularly in the customs and inland revenue areas. To date there had been no formal request in terms of providing assistance in budget management and expenditure control. The staff had made it clear that the institution would stand ready to support capacity building in that area.

Mr. Keller made the following statement:

> The economic situation in Eritrea presents a somewhat mixed picture. Against a background of very fragile productive capacities, important early progress has been achieved, in the first couple of years of independence, with respect to growth, price stability, and balance of payments and structural consolidation. However, economic performance in 1995 calls to mind many of the traps which loom for economies like Eritrea's. It is now the time—and it urges—to stem possibly devastating trends, and take a number of key policy decisions.
>
> We believe that the technical, political and financial backing of a Fund arrangement could help the Eritrean authorities to strengthen their analytical and administrative implementation capacities, while providing the necessary resources to establish a more solid base for economic growth. There is no doubt that Eritrea will have to rely, for quite some time, on good and stable relations with international donors for the financing of its balance of payments needs, and it is needless to say that a Fund program would help. We would welcome the staff's assessment on the Eritrean authorities' views on the possibility of a program in a not too distant future.

There are many challenges, and I will mention three. First, fiscal policy is carrying a heavy load, in particular with respect to economic reconstruction and social rehabilitation. While nontax revenue collection has responded well to the measures, additional efforts should now be focused on the legal and administrative aspects of taxation. On the expenditure side, the development of efficient administrative structures merits attention. In this context, we wonder whether the high outlays in 1995 for combatants' compensation, civil service retrenchment, and assimilated programs have been a one-shot operation, or whether they are of a more recurrent nature, and thus would raise more concern.

Second, the present, uncoordinated financial relations with the birr area are clearly not sustainable, and the negative interest differential with Ethiopia bears a high cost for Eritrea. In the short term, while preparing—hopefully with Fund assistance—the introduction of a national currency, domestic interest rates should be unilaterally brought in line with those in the major part of the currency area, with the double advantage of stemming capital outflows and consolidating domestic credit developments. In parallel, exchange liberalization should be given due attention.

Finally, the advantage of having started nationhood without a foreign debt is an invaluable capital which has to be managed with great care. The Eritrean authorities are right not to forget that a balanced economic policy is the precondition for keeping the need for non-grant and non-concessional foreign financing down—a stance which would be acknowledged.

Mr. Rainford made the following statement:

Eritrea is still in the relatively early stages of state formation, following its declaration of independence in 1993, and still has some considerable way to go in developing its social, economic, and financial institutions. Understandably, therefore, there is still an air of tentativeness in Eritrean affairs, including in relation to the scope and quality of available statistical data (e.g., government financial data are available only on a cash basis). Nevertheless, depending on how the authorities orient their policies and their actions in the near term, the outlook for the country could be promising and positive.

Evidence of restoration of economic activity in the wake of the long and destructive war of independence, has been encouraging. In particular, with only 11 percent of Eritrea's 3 million hectares of arable land under cultivation, there is considerable potential for vigorous expansion of agriculture and fisheries, notwithstanding the impact of periodic droughts. Very important, the authorities while laboring under tight constraints of all types, have generally shown a broad commitment toward sensible reforms. In this connection they are to be highly commended for action already taken to rationalize the government machinery and downsize the civil service, and for plans under way to improve and modernize the financial system.

But the country remains at a kind of crossroads. While the staff correctly believes there are good prospects for improved growth, the authorities face a strong challenge to complete the establishment of the required institutional framework, adhere consistently to strong domestic policies, and secure adequate external concessionary financial flows, to make such growth sustainable. The recent weakening of government finances and of the external current account is therefore troubling.

I agree with the staff that an immediate priority for the authorities is a sharp narrowing of the government deficit which remains high, even including grants. The monetary financing of the deficit is very troubling, and is evidently the main impetus behind the strong upward movement of inflation and the deterioration in the external current account in 1995. I note that the staff believes that strong efforts are needed on the revenue side, but with revenues (excluding grants) already standing at nearly 29 percent of GDP in 1995 (which is quite high for a country in Eritrea's circumstances) this effort is presumably to preserve this ratio and avoid the projected drop to 27½ percent of GDP in 1996. It appears the bigger challenge is for expenditure restraint, and here, even allowing for the impact of civil service downsizing that has already taken place, there is a need for further containment of government wage costs, which surged to 13½ percent of GDP in 1995. The projected moderation of government wage costs to 11 percent of GDP in 1996 will hopefully be realized as a clear beginning of a process of further containment. Generally, the authorities may need to follow a strategy of maintaining a carefully prioritized core expenditure programme, including public investment, that stays close to the level of domestic revenue, along with other expenditure plans whose implementation would be linked to the flow of external assistance. I would welcome the staff's comment here.

Early and focused action is called for in the financial system as well, and the staff has clearly highlighted the elements of modernization to be pursued. We welcome plans to introduce legislation to consolidate the position of the Bank of Eritrea, and to permit licensing of foreign and locally owned private banks, thus breaking the monopoly of the government-owned Commercial Bank of Eritrea. It should be emphasized that care should be taken to establish a strong bank inspection function, presumably in the central bank, among the other areas of capacity enhancement being addressed.

Importantly, it is interesting to note that the authorities are resolving the currency situation by moving toward the establishment of Eritrea's own national currency. Though trade and social linkage with Ethiopia remain significant, and though there have been attempts at cooperation and coordination between the two governments, joint monetary management between the two sides does not seem likely to strengthen sufficiently to justify Eritrea's continued use of the Ethiopian birr as its currency. We therefore support the move toward establishment of an Eritrean national currency. At the same time, we endorse the staff's advice that this should be carefully timed to follow a marked strengthening of policies in order to ensure confidence in the new currency. We also join in encouraging the authorities to end the multiple currency practice now prevailing, certainly by the time of the introduction of the new currency if this takes place reasonably early, or before, if not.

In the structural area, in addition to the welcome reforms already implemented or being pursued in the areas of the government machinery and the financial system, we also strongly urge the authorities to proceed with public enterprise reform and divestment in a more focused and expeditious manner. Getting rid of the deadweight of poorly performing public enterprises would increase flexibility in the economy by reducing subsidies and transfers in the government budget, thus helping to remove the need for domestic financing of unsustainable fiscal deficits, and at the same time, provide opportunities for mobilizing private sector energies.

Finally, the authorities would be well advised to consider carefully whether Eritrea would not benefit from an ESAF agreement with the Fund. The rigor and discipline that could come with a well designed and effectively monitored ESAF arrangement could enhance the prospects for a durable reduction of imbalances and help ensure technical assistance and adequate concessionary financial flows within a comprehensive medium term macroeconomic framework. Such an initiative could be decisive in helping Eritrea make the right turn at the crossroads at which it now stands.

I wish the authorities well in their future endeavors.

Mr. Kyriacou made the following statement:

Years of devastating wars and recurrent droughts contributed to the deterioration and virtual destruction of Eritrea's economic, social, and administrative infrastructure. The staff effectively depicts the difficulty of the situation. The literacy ratio of 20 percent among adults and the life expectancy at birth of 46 years are two of the many grave indicators that shape the framework of economic analysis in Eritrea.

I am in broad agreement with the staff appraisal and conclusions, and therefore I will focus on only a few points for emphasis. The task for the authorities, particularly as regards structural reforms, is daunting, as virtual reconstruction of the economy is needed. Nevertheless, it is encouraging to note that a number of courageous reforms have been undertaken in recent years. The authorities are encouraged to continue their efforts so that these reforms are strengthened and reinforced with additional appropriate measures on all economic fronts. These measures should be aiming at improving the administrative capacity of the country and promoting private sector initiative, thus setting the stage for sustainable growth.

In addition, many of these structural reforms are necessary to pave the way for the introduction of a new national currency. Already, partly because of the initial structural reform efforts, a number of encouraging economic signs are emerging, such as positive real per capita GDP growth and relatively low inflation. Even though the absolute numbers of these indicators need to be considered with great caution, as data quality is poor, they, along with other evidence, suggest that the economy is heading toward the right direction, provided, of course, that the appropriate supportive policies continue.

Along with the great challenge of restructuring the economy, the restoration of macroeconomic imbalances is another urgent challenge for the authorities. For instance, the understandably pressing needs for extraordinary government expenditure have to be balanced with the need for fiscal consolidation. I agree with the staff that prioritization of expenditure along with further improvements in tax administration are vital elements of prudent fiscal policy.

Finally, this chair agrees with the view expressed in the staff report and by Mrs. Guti that Eritrea needs adequate and timely concessional financial assistance from the international community. In this context, the authorities are encouraged to seek the financial support of the Fund as soon as possible.

Mrs. Paris made the following statement:

In 1995, despite a noticeable weakening of the fiscal situation, the major restructuring of the central and local governments that was implemented should be seen as an encouraging step toward restoration and maintenance of a sustainable fiscal position in the medium term. Yet, the current expansionary fiscal policy stance should be resolutely corrected. Although the inflationary impact of the deterioration of the fiscal deficit in 1995 is not obvious in a country that is not in a position to print money, unsustainable government indebtedness is certainly to be avoided. Like the staff, I urge the authorities to put in place a comprehensive budget that would enhance revenue performance and carefully prioritize public expenditures.

With regard to monetary policy, I cannot but echo the staff's and previous speakers' recommendation to strengthen coordination between Eritrea and Ethiopia, in the context of the de facto currency union: differential in interest rates in particular should be eliminated. I also agree that a prudent fiscal policy and a strengthening of the Bank of Eritrea capacity to conduct monetary and exchange rates policies are essential conditions for a successful introduction of a national currency.

Beyond this, however, scarcity and poor quality of economic data make it specially difficult to assess macroeconomic performance in Eritrea. The lack of official national accounts or any comprehensive price statistics in particular limits considerably the understanding of the real sector and, as a result, restricts effective policy formulation. This should be addressed forcefully: like the staff, I welcome steps being taken to strengthen the capacity of the National Statistics Office. Yet, I wonder whether the Fund could not take a more proactive role in assisting Eritrea to build a stronger economic and financial data base. I would appreciate the staff's comments on this.

Mr. Nemli made the following statement:

Eritrea has achieved commendable results since obtaining independence in 1993, but still faces the challenge of providing an adequate livelihood for its population. Though economic performance improved following independence, the fiscal and monetary situation deteriorated sharply in 1995, threatening the continuation of the country's development process.

Eritrea will depend heavily on foreign financial assistance for years to come, and in light of the so-called "aid fatigue" afflicting the international donor community, it is absolutely vital that Eritrea pursue sound, pragmatic economic policies.

Since I agree with the views expressed in the staff's report, I can limit myself to a couple of brief observations.

Eritrea's fiscal situation is especially worrisome with the public deficit, excluding grants, has reached an astonishing 28 percent of GDP. It is essential for the authorities to correct this severe imbalance with both revenue and expenditure measures; and although Eritrea's revenue performance has improved substantially in recent months, severe weaknesses still remain. In fact, this good revenue performance is based on non-recurrent revenues. This is the reason that tax revenues increased by only 9 percent. It is extremely worrisome that expenditures have increased by 33 percent during 1995. The staff suggests that it might be possible for some of these expenditures to be phased in gradually over a period of years. This would probably give the authorities more room for maneuver when designing fiscal policy.

On monetary policy, we agree with the staff that many conditions, including fiscal credibility, must be satisfied before a new currency can be introduced. I also wonder, given the close ties between Eritrea and Ethiopia, if the authorities of these two countries have considered setting up a monetary union between them?

As to the country's future relations with the Fund, Eritrea's first step should be to prepare a "National Policy Framework Paper" as a basis for a staff-monitored program, and seek the Fund's financial support only after the program is implemented and the balance of payments outlook is more clearly visible.

In conclusion, we wish the authorities all the best in their future endeavors.

Mr. Kpetigo made the following statement:

Since its independence in 1993, Eritrea has continued to implement far-reaching measures aimed at stabilizing the financial sector, reconstructing the economy and improving the social infrastructure, namely education and health. Moreover, real GDP growth averaged about 4 percent a year during 1993–95 and is expected to be higher in 1996. Meanwhile, inflation has remained moderate and in the external sector a modest surplus was recorded in the balance of payments. However, developments in 1995 and the prospects of 1996 seem to indicate a deterioration in the economic situation, particularly in the financial sector.

Since I share the views expressed by the previous speakers I will limit myself to some specific issues, for emphasis, relating to the fiscal and monetary policies.

On fiscal policy, we note that the fiscal position worsened significantly, as a result of a surge in expenditure, mainly on account of pressing requirements for education and health. While this deterioration is understandable, given the present situation of Eritrea, we, however, urge the authorities to take steps so as to keep the financial stabilization process on course. To this end, we concur with the staff that the government should reduce significantly the fiscal deficit in order to restore the macroeconomic stability. In this regard, we are of the view that substantial reductions in marginal income tax rates, sales tax rates, and customs duties rates, in the face of increased expenditure, appear to be counterproductive for tax receipts at this juncture.

While urging the authorities to be prudent as to financial compensation and retroactive wage payments, we would also urge them to focus primarily on capital expenditure to improve and restore the physical infrastructure destroyed during the war and to rebuild the economy.

On monetary policy, we note that as a reflection of the decline in foreign assets, credit developments were expansionary in 1995, namely, the sharp increases in net claims on government. This, coupled with the expansionary fiscal measures, could result in a sharp rise in broad money, with inflationary effects. These trends will need to be corrected, and I can associate myself with the suggestions made by the staff and previous speakers in this regard.

Regarding the introduction of a national currency, I agree with the staff that this should be carefully prepared. More important is the implementation of tight fiscal and monetary policies to lay the basis for a successful new exchange regime.

We commend the authorities for their efforts in putting in place a sound Investment Code aimed at providing a number of incentives to private operators and in phasing out the remaining controlled prices and for merging a number of central government agencies to achieve efficiency gains. We welcome the new civil service salary scale and hope that its adoption will contribute to increase efficiency.

To conclude, I would encourage the Eritrean authorities to improve the macroeconomic database and restore the official national accounts statistics.

To this end, they will continue to count on the Fund's technical assistance, as stated by the staff and by Mrs. Guti.

With these remarks, I wish every success to the Eritrean authorities in their endeavor.

The staff representative from the African Department stated that the authorities expected future economic growth to be driven by traditional sectors such as mining, tourism, and fisheries, by efficiency gains in agriculture, and by a moderate expansion of the industrial sector. Fiscal revenues, expressed as a percentage of GNP, were high relative to the regional norm, largely because Eritrea benefited from transit fees. The tax component of the fiscal revenues remained relatively low—in the range of 13–14 percent of GNP—and could, potentially, become a larger contributor to the budget in the future. The sales and excise tax base could be broadened, and tax administration and compliance could improve.

Regarding the issue of Eritrea's possible request for a program, the staff representative indicated that, being a relatively new Fund member, the country still needed to increase its experience with the Fund and its policies. At present, the authorities were considering a number of options, including a national policy framework paper and the possibility of a request for an ESAF. Eritrea would attach significant importance to ownership of any program ultimately chosen.

The Chairman noted that the desire of the Eritreans to own their own future was something that the Fund should encourage, and build on.

Mrs. Guti, in her concluding remarks, emphasized that the authorities were prepared to take necessary measures to bring the budget under control. They were also ready to cooperate with the Fund and the international community. Such cooperation would produce successful results provided the country was assured of its ownership of the program.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. They commended the considerable progress that Eritrea has made in the two years since independence in restoring growth, economic reconstruction, and deregulating economic activities. Directors stressed that continued structural reforms and disciplined financial policies were critical in meeting the challenges that lay ahead in building the foundation for sustainable growth. In that context, Directors noted that, while economic growth continued to recover in 1995, there were also signs of a weakening of the macroeconomic situation, particularly the recent acceleration in inflation and the deterioration in the external accounts, which reflected the widening fiscal imbalance financed by a sharp expansion in domestic credit.

Directors stressed the importance of a major fiscal consolidation effort in order to contain demand pressures, avoid unsustainable government indebtedness, and facilitate private sector development. The authorities were urged to accelerate the preparation of a comprehensive and coherent budget, and to take steps to mobilize additional revenue by widening the tax base and improving customs and tax administration. Directors expressed concern about the rapid growth in current expenditure, which was not sustainable, and called for early action to contain recurrent expenditures and strengthen expenditure management. Given the considerable reconstruction needs, there was also a need to better prioritize public investment. Directors also stressed the need to ensure that the planned introduction of the new salary scale is consistent with the attainment of the overall fiscal objectives.

Directors advised the authorities to moderate the growth of domestic liquidity and credit in 1996 by taking measures to absorb excess bank liquidity. They also emphasized the need for close coordination of monetary policy within the de facto birr currency union. With regard to the planned introduction of a national currency, Directors stressed that currency conversion would have to be preceded by the following: a sufficient tightening of financial policies, especially fiscal consolidation, to ensure confidence in the new currency; the establishment of an appropriate legal framework for the financial system; and a strengthening of the central bank's capacity to conduct independent monetary and exchange rate policy, including careful preparation for the transition to a new exchange regime and to an appropriate exchange rate. Speakers also urged the authorities to work toward the development of indirect monetary policy instruments, including the phasing out of credit allocation, and a competitive and modern financial system. Noting that the prevailing negative interest rates were not conducive to savings mobilization, several Directors called for greater flexibility in interest rates.

Directors noted the inherent weaknesses in Eritrea's medium-term external outlook, and emphasized that it would be important to develop export-oriented activities and diversify export markets. Concern was expressed about the erosion of competitiveness, as reflected in the appreciation of the real effective exchange rate; that underscored the need to tighten financial policies. Directors stressed that Eritrea should rely on foreign direct investment and concessional external loans to meet its investment requirements. They welcomed the initial steps taken to liberalize the exchange system, and encouraged the authorities to phase out the remaining restrictions on the making of payments and transfers for current international transactions.

Directors welcomed the structural reform measures undertaken, including the decontrol of prices, the introduction of a liberal investment code, and the restructuring of the civil service. They emphasized that a sustained implementation of structural reforms would be essential for improving growth prospects and easing constraints on private investment. In that context, Directors encouraged the authorities to take further steps to accelerate the privatization program, deregulate private economic activity, and phase out the remaining controls on prices.

Directors emphasized that, to enhance policy formulation and monitoring of developments, it was important to strengthen the macroeconomic database, and they urged the authorities to intensify their efforts in that regard. Directors hoped that a strong record of policy implementation would provide the basis for an ESAF arrangement once the authorities would have prepared their own national economic medium-term program. They also emphasized the need for technical assistance.

It is expected that the next Article IV consultation with Eritrea will be held on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1996 Article XIV consultation with Eritrea in the light of the 1996 Article IV consultation with Eritrea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/96/120, Eritrea maintains exchange restrictions on the making of payments and transfers for current international transactions including limits on travel, medical, and education allowances, as well as a multiple currency practice arising from the auction and preferential rates for the birr. The Fund encourages Eritrea to eliminate all restrictive exchange measures as soon as circumstances permit.

Decision No. 11275-(96/56), adopted
June 12, 1996

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/55 (6/7/96) and EBM/96/56 (6/12/96).

5. APPROVAL OF MINUTES

The minutes of Executive Board meetings 95/22 and 95/47 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/96/91 (6/6/96) is approved.

APPROVAL: April 28, 1997

REINHARD H. MUNZBERG
Secretary

authorities would have prepared their own national economic medium-term program. They also emphasized the need for technical assistance.

It is expected that the next Article IV consultation with Eritrea will be held on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 1996 Article XIV consultation with Eritrea in the light of the 1996 Article IV consultation with Eritrea conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/96/120, Eritrea maintains exchange restrictions on the making of payments and transfers for current international transactions including limits on travel, medical, and education allowances, as well as a multiple currency practice arising from the auction and preferential rates for the birr. The Fund encourages Eritrea to eliminate all restrictive exchange measures as soon as circumstances permit.

Decision No. 11275-(96/56), adopted
June 12, 1996

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/96/55 (6/7/96) and EBM/96/56 (6/12/96).

5. APPROVAL OF MINUTES

The minutes of Executive Board meetings 95/22 and 95/47 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAM/96/91 (6/6/96) is approved.

APPROVAL: April 28, 1997

REINHARD H. MUNZBERG
Secretary