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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 94/82

10:00 a.m., September 9, 1994

Contents

Executive Board Attendance

S. Fischer, First Deputy Managing Director
P. R. Narvekar, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	M. Sirat
J. Bergo	E. Srejber
	J. Dorrington
K. P. Geethakrishnan	V. Trivedi, Temporary
J. E. Ismael	
D. Kaeser	K. Link
	R. F. Cippa, Temporary
A. Kafka	
	A. V. Mozhin
W. Kiekens	A. Cserés, Temporary
	V. Kural, Temporary
	N. Coumbis
	M. Giulimondi, Temporary
	J. C. Martinez Oliva, Temporary
K. Lissakers	J. M. Abbott, Temporary
	M. Brettschneider, Temporary
	G. Torres
H. Mesaki	T. Fukuyama
	T. Oya, Temporary
A. Mirakhor	S. Rouai, Temporary
	B. S. Dlamini
	J. O. Aderibigbe, Temporary
G. A. Posthumus	O. Havrylyshyn
	J. W. van der Kaaij, Temporary
C. V. Santos	Y.-M. T. Koissy
	N. Toé, Temporary
S. Schoenberg	E. Wagenhoefer
	G. M. Blome, Temporary
A. S. Shaalan	Y. Y. Mohammed
D. E. Smee	N. L. Laframboise, Temporary
E. L. Waterman	Y.-H. Lee, Temporary
Zhang M.	B. Wei
	Wang, X., Temporary
A. G. Zoccali	J. Ortiz Vely, Temporary

L. Van Houtven, Secretary and Counsellor
S. Bhatia, Assistant
M. Miller, Assistant
C. Clarke, Assistant

Also Present

IBRD: S. Fardoust, South Asia Regional Office. African Department: E. L. Bornemann, Deputy Director; P. L. Dhonte. Central Asia Department: G. M. Meredith. European I Department: M. Russo, Director; J. R. Artus, Deputy Director; S. G. B. Henry. European II Department: J. Odling-Smee, Director; J. G. Anderson, J. R. Wein. External Relations Department: S. J Anjaria, Director; M. R. Kelly, Deputy Director; G. Hacche, J. E. McEuen, T. S. Walter. Fiscal Affairs Department: F. C. Ribe. IMF Institute: S. Nawaz. Legal Department: W. E. Holder, Deputy General Counsel; R. Munzberg, Deputy General Counsel; J. L. Hagan, Jr., J. K. Oh. Middle Eastern Department: P. Chabrier, Director; S. H. Hitti, Deputy Director; A. C. A. R. Furtado, H. Hirschhofer, G. M. Iradian, R. Moalla-Fetini, S. S. Rizavi, S. M. Tareq. Monetary and Exchange Affairs Department: C. Enoch, B. K. Short. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; F. C. Adams, B. J. Aitken, M. Allen, A. R. Boote, B. Christensen, S. V. Dunaway, J. Heemskerk, B. Horvath, S. Ishii, C. J. Jarvis, A. C. Kouwenaar, R. F. Krieger, M. G. Kuhn, K. H. Lee, E. C. Offerdal, S. C. Prowse, C. Puckahtikom, R. K. Rennhack, A. Singh, J. Zhou. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; M. S. Khan, Deputy Director; D. Coe, R. A. Feldman, R. P. Ford, S. J. A. Gorne, M. Hargraves, A. Hoffmaister, T. Ito, V. R. Koen, F. Larsen, M. A. Pradhan, S. H. Samiei, S. A. Symansky. Secretary's Department: A. Mountford. Southeast Asia and Pacific Department: K. B. Bercuson. Treasurer's Department: K. Christou, C. A. Hatch, O. Roncesvalles, G. S. Tavlas. Western Hemisphere Department: S. T. Beza, Counsellor and Director; W. Lee, C. M. Towe. Office of the Managing Director: S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant; M. El-Erian. Advisors to Executive Directors: M. A. Ahmed, B. Andersen, M. C. B. Arraes, S. K. Fayyad, G. Y. Glazkov, R. Kannan, N. Mancebo, M. F. Melhem, M. J. Mojarrad, J.-C. Obame, T. Oya, B. A. Sarr, Yang X. Assistants to Executive Directors: R. N. A. Ally, S. Arifin, A. G. Cathcart, J. A. Costa, D. Daco, J. Dagustun, G. El-Masry, S. S. Farid, A. Galicia, H. Golriz, O. Himani, T. Kanada, W. C. Keller, A. M. Koulizade, E. Kouprianova, K. J. Langdon, J. Mafararikwa, S. C. McDougall, S. Narube, J. Pesola, H. Petana, C. F. Pillath, D. Saha, F. A. Schilthuis, R. von Kleist, S. Vori, Wang Y., J. B. Wire.

1. PAKISTAN - ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REVIEW UNDER FIRST ANNUAL ARRANGEMENT, AND REVIEW UNDER EXTENDED ARRANGEMENT; AND EXCHANGE SYSTEM

Executive Directors considered a staff paper on the midterm review under the first annual arrangement under the enhanced structural adjustment facility (ESAF) for Pakistan and the first review under the extended arrangement (EBS/94/159, 8/16/94; and Sup. 1, 9/7/94).

Mr. Mirakhor made the following statement:

My authorities wish to thank the staff for having produced a high-quality report on Pakistan. The authorities' recent accomplishments in the area of macroeconomic stabilization and structural reforms, as well as the challenges that lie ahead are clearly set out in the report. The authorities are in substantial agreement with the staff analysis and policy recommendations.

Directors will recall that the Executive Board last discussed Pakistan in February this year in the context of the 1993 Article IV consultation and Pakistan's request for arrangements under the enhanced structural adjustment facility (ESAF) and the extended Fund facility (EFF). At that time, Executive Directors commended the Pakistan authorities for the "decisive policy measures" they had taken during the first half of 1993-94 to tighten financial policies and accelerate the process of structural reform. They also welcomed the new Government's endorsement of the three-year policy framework paper, which they saw as an important signal of the continuity of economic policies in Pakistan. Directors described the program as a solid and challenging one. It was clear, however, that it would require strong political resolve and determination to carry it through. Particular emphasis was placed on the crucial importance of sustaining the fiscal deficit reduction effort which, given past slippages, had been a major contributor to financial imbalances and had tended to undermine gains from structural reform.

Against this background, and despite difficult economic conditions in the form of the cotton virus, the drought and related power shortages, which hurt domestic activity and exports, the economy has performed well. The program is solidly on track, both in terms of its quantitative targets and the implementation of the structural measures that have been taken.

The strength of the authorities' adjustment effort is most evident in a significant reduction in financial imbalances. In the domestic sphere, the fiscal deficit in 1993-94 was reduced by over 2 percentage points of GDP, the largest reduction in the fiscal deficit in a single year. This is all the more noteworthy when one considers the pressures on the budget that arose from shortfalls in revenues associated with the weakness in domestic activity and imports. The steep fall in the deficit was associated with a corresponding sharp cutback in budgetary financing--from PRs 64 billion in 1992-93 to only PRs 13 billion in 1993-94--and well below the target.

Monetary policy was kept tight with the lower than programmed growth in net domestic assets being offset somewhat by the strong external position.

In the external sector, despite the setback to the agriculture sector which resulted in a 33 percent decline in cotton output and a 70 percent fall in exports of raw cotton, the current account deficit was cut by more than one half, from over 7 percent of GDP in 1992-93 to 3.5 percent of GDP in 1993-94, as programmed. The overall balance of payments position swung from a deficit of $589 million in 1992-93 to a surplus of $1,514 million--a turnaround of over $2 billion in one year. This enabled Pakistan to reconstitute its gross reserves position to a level in excess of the programmed target and to substantially reduce the economy's exposure to foreign currency liabilities. The favorable external outcome reflected a decline in the level of imports to more sustainable levels, robust growth in nontraditional manufactured exports, which helped cushion the effects of the fall in raw cotton and cotton-related manufactured exports, and, on the capital account, a surge in portfolio and direct foreign investment inflows, which occurred in response to a return of confidence in the management of the economy.

Developments on the growth and inflation front were, however, less favorable. With respect to growth, the shortfall was due to the adverse effects of the virus and the drought on domestic activity and a negative external impulse emanating from a slowdown in export growth. At a presently estimated 4 percent, real GDP growth in 1993-94 was well below potential for a second year in a row although much improved over the previous year's flood-impacted level. At the same time, the authorities found getting the headline inflation rate down a frustratingly difficult task. However, unlike the past, when inflation owed its momentum to insufficiently tight demand management policies, it was clear that the stickiness of inflation was due to the coincidence of strong cost pressures and the economy's weak supply response. These included the lagged effects of the pass-through effects of the exchange rate adjustment in mid-1993, the steep increase in a number of key administered prices--petroleum, edible oils, gas and, more recently, wheat--and the supply disruptions in the agriculture sector. While the headline rate of inflation in 1993-94 exceeded the program target by about 3 percentage points, the authorities' calculations suggest that the core rate of inflation, which excludes the one-time impact of the above measures, has responded well to the underlying stance of macroeconomic policies.

With the immediate balance of payments crisis overcome and the economy in a much stronger position, some may have thought that the Government might be tempted to relax the stance of its macroeconomic policies and shy away from the politically unpopular decisions that would be required to keep the program on track in 1994-95. To be sure, there were intense pressures to do so. In the event, the authorities once again signaled their strong adherence to a macroeconomic strategy aimed at fiscal consolidation and price stability even if it meant challenging formidable vested interests. Difficult decisions were taken in the face of widespread strikes and protest from the business community once the budgetary decisions were announced. The staff paper provides a comprehensive description of the measures that have been taken in the context of the 1994/95 budget and the related Trade Policy Order. It will suffice to highlight the substantial revenue effort--equivalent to 2.6 percent of GDP in gross terms--the very significant improvement in the structure of revenues through a broadening of the General Sales Tax net, the enhancement of income, wealth, and profit taxation, a broadening of the base of taxation of agriculture incomes in two provinces, which follows the historic enactment of the federal wealth tax on agriculture early this year, and a strengthening of the excise taxation system. In addition, important steps were taken in the external area: Pakistan accepted the obligations of Article VIII on July 1, 1994 and now maintains an exchange system that is free of restrictions on current international transactions. Trade taxes were cut sharply as part of the medium-term tariff reform program, while exemptions and concessions were concurrently reduced and rates were consolidated. In the case of items prone to smuggling, the maximum tariff was lowered from 92 percent to a range of 35-45 percent. Expenditures are to be contained through tight limits on the wage bill and a containment of defense outlays. On the other hand, reflecting the urgency of making visible progress in redressing the inherited backlog of unmet social needs and implementing high-priority investments in power generation, transport and water management, development expenditures were increased by close to 25 percent over year-earlier levels.

The authorities' tight fiscal stance in 1994-95 is to be reinforced by a restrained monetary policy. This is viewed as being essential to bring aggregate demand into better alignment with the economy's supply potential, further strengthen the external position and reduce inflation. Indeed, it is expected that with the fiscal deficit under better control and on a firmly downward path, monetary policy can play a larger role in guiding the economy toward a more sustainable path. Accordingly, the conduct of monetary policy is to be enhanced by progressively greater reliance on indirect monetary control instruments through, inter alia, improving the effectiveness of treasury bill auctions as an instrument of monetary control, imposing strict limits on the scope of concessional and government-directed credits, and strengthening bank supervision and regulation.

The pace of privatization is expected to accelerate in 1994-95. The authorities have moved cautiously in this area but this was an understandable response to earlier concerns about the transparency of the process. In addition to making progress on the remaining industrial units and banks, the Government has obtained the necessary parliamentary approval for the privatization of the large telecommunications corporation (PTC) and the Water and Power Development Authority (WAPDA). Directors may be aware of the market's enthusiastic response to an initial share offering in PTC which was massively oversubscribed and attracted $700 million in three days. There has also been an overwhelming response from domestic and foreign private investors to the Government's new energy policy which, inter alia, guarantees a remunerative price for bulk sale of power to the national grid. The Hub power project, one of the largest private sector power projects in the world, has started construction. The private sector is also being encouraged to participate in such areas as roads, railways, airlines, insurance, mining, investment, and commercial banking. The proceeds from privatization will be used to meet the costs of worker retraining, to retire the public debt, and to finance a portion of the Government's ambitious Social Action Program (SAP).

The authorities believe that the set of macroeconomic and structural policies for 1994-95 constitute a strong and comprehensive agenda of actions which, assuming a return to more normal weather conditions, holds the promise of a significant upturn in activity. Growth is expected to rebound to near potential as the margin of slack is taken up. This is to be accompanied by an easing of inflationary pressures and a further strengthening of the balance of payments. This may be expected to contribute to greater stability of the nominal exchange rate and reinforce the firm anti-inflation posture of macroeconomic policies. Developments in the first few months of 1994-95 suggest that the economy is showing signs of renewed vitality. Nontraditional exports showed continued dynamism; inflation is on a downward trend; and despite heavy rains and some flooding, the all-important cotton crop appears to be in good condition with no signs of the leaf curl virus or other damage.

Given the wide-ranging nature of the effort on the structural front, there is some uncertainty as to how the fiscal position will evolve in the months ahead. This is particularly the case with the large domestic revenue effort and the impact of the liberalization of imports on volume and revenues. Much will depend on the timing and nature of the rebound in domestic demand and imports. The authorities will watch the situation closely and take timely corrective measures to offset any emerging deviations, while being mindful of the need to protect the public investment program. My authorities look forward to exploring these and other policy issues with the staff during the course of the upcoming discussions on the second annual ESAF arrangement in October-November this year.

Let me conclude by saying that my authorities will remain resolute in their determination to adhere to sound economic policies and to foster confidence in domestic and external markets. While the full benefits of their strong adjustment effort on the closely watched--and politically sensitive--indicators such as growth and inflation have been slow to materialize, they remain convinced that their persistence with the adjustment effort will soon bear fruit and that the program offers the best prospect for an early return to a sustainable path of higher growth with price stability.

Mr. Shaalan made the following statement:

At the time the Executive Board considered Pakistan's request for ESAF and extended arrangements earlier this year, I had noted that the policy package supporting these arrangements was comprehensive, far reaching, and properly sequenced. To no small degree this was a result of the close collaboration between the authorities and the Fund staff. I would like to take this opportunity to commend the staff for their most outstanding work.

It is heartening to learn that Pakistan has met all the performance criteria under the arrangements. It is also extremely encouraging that, despite adverse exogenous shocks occasioned by the cotton virus and the drought that undoubtedly complicated economic management, the economy has responded well to the implementation of the adjustment program. Here I would like to note that the precarious foreign exchange situation of July 1993 has been corrected, and international reserves now stand at a comfortable level. This development was occasioned in part by the buoyant growth in nontraditional exports and the favorable response of foreign direct and portfolio investments. I commend the Pakistan authorities for their achievements thus far.

As I am in full agreement with the staff analysis and appraisal, I will limit my remarks to three key issues, which I believe merit emphasis and attention. These relate to fiscal adjustment, the role of the central bank, and the external financing program.

The lessons of the past decade clearly guided the authorities in the formulation of their fiscal adjustment and consolidation program. Indeed, this area was an important pillar in the reform program. Not only did the program emphasize the importance of additional reduction in the fiscal deficit but, more important, this was accompanied by improvements in the budget's structure. Both these aspects were viewed as critical components of the medium-term economic and financial strategy, not only in the fiscal area, but more broadly in terms of correcting the past overburdening of other financial policy instruments. In this connection I would note, in particular, the appropriately sequenced reform of the indirect tax system which centered on the gradual broadening of the General Sales Tax, tariff reform, and the widening of the direct tax net. I would urge the authorities to maintain the fiscal reform momentum. I have no doubt that the authorities are fully cognizant of the risks associated with a premature relaxation of the fiscal consolidation effort. The experience of the late 1980s and early 1990s clearly testify to these dangers.

As noted above, fiscal consolidation affects macroeconomic management more broadly by providing greater scope for a more active monetary policy, which has also been enhanced by the increased autonomy of the State Bank of Pakistan. In this connection, I applaud the State Bank in its successful handling of the budget constraint on bank financing of provincial operations. It should be recalled that this area had been a weak link in Pakistan's fiscal policy. Moreover, the State Bank has been successful in putting in place the necessary institutional strengthening of its own capabilities to conduct monetary policy, based on greater reliance on indirect monetary controls. Continued progress in these areas is essential, along with the intended reduction in the scope of government-directed credit. I note here the valuable contribution of Fund technical assistance, and I strongly support the continued provision of such assistance in key areas of structural reform.

The last area I would like to highlight is the external financing program. This is an important area in view of the periodic foreign exchange difficulties the country has experienced in the past. Accompanying the domestic adjustment measures is a carefully managed external financing program. This includes limiting reliance on short-term credit lines, improving the utilization of concessional funding, reducing the economy's vulnerability on account of foreign currency accounts, and broadening access to medium-term financing instruments. Regarding the latter, I note from the staff paper that the authorities are in the process of arranging for their first sovereign Eurobond issue. This is an important landmark in Pakistan's international financial relations. The importance of this bond issue transcends the funding that is being raised; it also provides for the establishment of a benchmark for subsequent private sector recourse to international capital markets. Staff comments on the key elements of the authorities' approach in this area would be appreciated.

I would like to conclude by commending the Pakistan authorities for their determined policy implementation. Considerable progress has been achieved so far. Nevertheless, as demonstrated by the staff's medium-term sensitivity analysis, important challenges remain. In wishing the authorities every success in facing these challenges, I would stress that the encouragement from the response of the economy to date augurs well for their continued success.

Mr. Dorrington made the following statement:

Pakistan's economy has responded well to measures taken so far under the medium-term adjustment program. The staff report paints an encouraging picture, and Supplement 1 confirmed it. The Government's success over the last year in reducing the fiscal deficit and building up its foreign exchange reserves is commendable. I congratulate the Government on having met all performance criteria under the ESAF and extended arrangements.

Extrapolating from Pakistan's good progress so far, the target of reduction in the fiscal deficit to 4 percent of GDP in 1994-95 remains achievable. But it is not yet in the bag. The Government's plans for additional revenue mobilization are ambitious, and we have yet to see how they work out in practice. While I therefore hope that contingency measures to offset slippages on fiscal targets prove unnecessary, I strongly endorse the staff's assessment that, should such slippages start to emerge, the Government should be ready to take timely compensating action. I welcome Mr. Mirakhor's reassurance on this point. There is no room for relaxation of the Government's drive to contain the overall level of expenditure while it shifts the composition of spending away from unproductive sectors and toward social sector spending and infrastructure support.

I support the proposed decisions.

Mr. Sirat recalled Mr. Autheman's memorandum, in which it had been suggested (see Attachment) that a full Board discussion was not necessary in view of Pakistan's fulfillment of all end-March and end-June performance criteria, and taking into account the comprehensive Board discussion on Pakistan in February.

Mr. Al-Jasser, commending the Pakistan authorities for the impressive achievements under the programs supported by the ESAF and EFF, noted that, despite adverse shocks in the form of a cotton virus, drought, and related power shortages, the economy had responded favorably to the adjustment efforts, and, hence, all the performance criteria had been met. Furthermore, the level of external reserves had exceeded the program target, thereby providing a comfortable cushion for the authorities to press ahead with their adjustment efforts. There were now clear indications of improved market perceptions of Pakistan's country risk.

In light of the substantial agreement between the staff and the authorities on policy recommendations, he agreed with Mr. Sirat that the review could have been treated on a lapse of time basis, Mr. Al-Jasser remarked. His authorities were supportive of Pakistan's adjustment program and, toward that end, the Saudi Fund for Development would be participating through an SDR 30 million disbursement in association with the current ESAF arrangement. Finally, he supported the proposed decisions.

Mr. Kural made the following statement:

The staff's reviews of developments under the first-year ESAF arrangement and under the extended arrangement show good progress in the public sector's financial situation and the structural reform process. The economy was hampered during 1992 and 1993 by severe economic and political uncertainty, and to compensate for the loss of momentum the authorities launched, under the present medium-term program, a frontal attack on financial imbalances which has succeeded, even in the face of supply-side shocks, in reducing them without very significant output losses.

In addition, the economic uncertainty of two years ago has been replaced by a comprehensive set of macroeconomic adjustment and reform policies, and beginning at the end of 1993, the economy began to recover. The main impulse came from demand: a tightening of domestic credit and budgetary conditions encouraged both domestic and foreign private investors, and increased external credit became available. Supply-side conditions have also improved significantly, owing to the progress made with structural reforms in such areas as public finances and financial intermediation, the liberalization of trade and domestic economic activities, and privatization.

But medium-term stability can only be achieved and maintained through continued fiscal adjustment and reform. To foster credibility and positive expectations, adjustment and reform must be seen as elements of a permanent policy of medium-term fiscal equilibrium. The fundamental task of shrinking the public sector will be a major test of the authorities' ability to make more effective use of monetary policy instruments. The deficit must be reduced further, and special action must be taken to correct the remaining anti-production biases of the tax system and improve the productivity of expenditures. We commend the authorities on their success in mobilizing revenues and cutting expenditures, and urge them to maintain this balanced approach, which favors their anti-inflationary efforts.

In addition to further reducing the fiscal and monetary imbalances, the authorities must take a close second look at how they might modify the operations of the treasury bill market to improve the mobilization and allocation of loanable funds. Further deregulation will help strengthen Pakistan's technical and institutional framework. The authorities must continue pursuing an appropriate exchange rate policy and further reduce the scope of government-directed credit schemes.

The potential of tightened domestic credit and budgetary conditions to damage the sustainability of economic growth brings the sobering realization that stabilizing the effects of the political turmoil of late 1992 and 1993, no matter how carefully it is done, will take a long time and must eliminate the institutional roots of the crisis. The most pressing immediate need in Pakistan's case was for a radical change in the direction of macroeconomic adjustment policy; I would now urge the authorities to make a strong political commitment to structural reform. The transition to medium-term stability and the overall sustainability of Pakistan's achievements cannot be assured unless the fundamentals are dealt with in the proper manner. I welcome Mr. Mirakhor's assurances on this matter.

Finally, substantial progress has been made with the authorities' privatization program. In this area we welcome the authorities' intention of restoring and maintaining the momentum of the privatization program. The obstacles to privatization must be resolutely eliminated and a public consensus obtained on the goals, principles, and priorities of privatization, followed by quick implementation. Such a program would help sustain the fiscal adjustment over the medium term and improve foreign confidence in Pakistan's continued commitment to serious economic reform.

I support the proposed the decisions.

Mr. Mozhin made the following statement:

To begin with, let me commend the authorities for their efforts in achieving the ambitious stabilization and adjustment objectives. The performance of Pakistan's economy since our last discussion has been encouraging--all end-March and end-June performance criteria and benchmarks established under the programs have been met. Although some indicative targets of the programs have been missed, I tend to believe that Pakistan's economy now firmly stands on the right track. As I agree with the thrust of the staff's analysis and support the proposed decisions, I will limit my intervention to several program areas.

My first comment is on the fiscal position. I welcome the authorities' efforts to improve the revenue structure and contain current expenditures, which have already resulted in the reduction of the budget deficit by 2.2 percent of GDP in 1993-94 compared to 1992-93. Further important steps aimed at increasing revenue collection were taken by the Government in February and June of 1994. Nevertheless, the current level of budget deficit of 5.8 percent is above the target, and further efforts are clearly needed in order to achieve the targeted level of 4 percent in 1994-95.

Turning to monetary policy, the inflation target has not been met, as the consumer price index for the 1993-94 has exceeded the target by 3.2 percent, and reached 11.2 percent. At the same time, I welcome the intention of the monetary authorities to reduce the scope of directed credits and increase their reliance on indirect instruments of monetary control.

In the external sector, quite remarkable progress has been achieved. By July 1994, gross international reserves had reached $2.3 billion, or 12.7 weeks of imports. The strengthening of the balance of payments position has been especially impressive, as it swung from about a half-billion dollar deficit in 1992-93 to about a 1.5 billion dollar surplus in 1993-94. The surge of private capital inflows already indicates that investors' confidence has improved significantly. Acceptance of Article VIII status in July 1994 is another indicator of the authorities' strong commitment to the maintenance of liberal exchange arrangements.

As is indicated in the staff report, Pakistan has established an excellent track record in servicing its debt obligations. In this respect, it is especially regrettable to learn that, beginning from 1993, there have been interruptions in servicing Pakistan's debt obligations to Russia. Although, as a result of bilateral discussions in June of this year, full payment of the 1993 debt servicing is now expected, the Pakistan authorities have requested renegotiation of the stock of the debt. In the view of my authorities, this amounts to a request for a debt reduction, which cannot be justified, either by the size of the debt or by Pakistan's reserve position.

Mr. Coumbis made the following statement:

During the last Board meeting on Pakistan, the Board commended the authorities for their comprehensive adjustment efforts and for having met the December performance targets. At the same time, the request for a transition to a program under the ESAF and extended arrangements was approved. This ambitious medium-term program has as its basic objectives, a substantial fiscal consolidation in a framework of tight demand management, a strengthening of the effectiveness of monetary policy, the liberalization of trade, and the removal of multiple currency practices. The implementation by the Pakistan authorities of this has, so far, been on the right track. Thus, gross international reserves reached $2.3 billion at the end of June surpassing the program target, while the current account deficit and net domestic assets were lower or at the program targets. However, while the budget deficit was contained to 5.8 percent of GDP against 8 percent in 1992-93 it was slightly above the indicative target. The main reasons were the lower than expected excise taxes, customs duties, and sales taxes because of lower than expected domestic activity. There are also deviations in GDP growth and in price increases. Thus, GDP increased by 4 percent as against a program target of 7.5 percent, and the price level increased by 11.2 percent while the target was 8 percent. Both deviations were the result of shortfalls in cotton and wheat production because of a cotton virus and drought.

It should be noted that the Pakistan authorities have consistently maintained tight demand policy during the 1993-94 period. As we said before, fiscal consolidation is the basic objective of this medium-term program. In that respect, we should remember that many reform programs in Pakistan have failed in the past, because of slippages in fiscal policies. This time, however, structural reform measures already applied for both taxes and government expenditures create the necessary condition for keeping the fiscal program on track.

For 1994-95, the authorities in the framework of the medium-term program will intensify their efforts for structural reforms. The basic targets seem ambitious: GDP growth of 6.6 percent, inflation rate of 7 percent, and an increase of official reserves to $2.86 billion. With respect to GDP growth and price increases, the targets are especially optimistic, given the frequency with which the Pakistan economy is hit by external shocks. In that respect, it is interesting to examine the sensitivity analysis of the base line scenario in the staff paper. It shows quite clearly the effects of the persistence of the virus-induced disruption in the cotton sector and the unfavorable developments in the terms of trade on the current account and on gross official reserves. In the first case, the official gross reserves will be decreased to about 5 weeks of imports in the year 1999-2000 as against 18 weeks in the base line scenario, while a sustained increase in the price of oil by 15 percent above the levels projected in the World Economic Outlook would decrease the reserve position at the end of the period by about 9 weeks below the base line scenario.

During 1994-95, the authorities are going to intensify their efforts in the areas of the tax system, public expenditure, monetary control instruments, banking supervision, trade policy, and privatization. The direction of the measures will be the same as last year and the emphasis will be on structural reforms. In this year, as in the previous one, the cornerstone of the efforts of the authorities will be fiscal adjustment as a precondition for financial stability and growth.

In the staff report, there is a detailed analysis of the policies that the authorities have to follow in 1994-95. As I am in broad agreement with the staff's analysis, I will only offer some comments on certain aspects of fiscal and monetary policy.

In the area of fiscal policy, I welcome the efforts of the authorities to broaden indirect taxation, to expand the use of withholding taxes, to broaden the base of agricultural taxation, and to improve excise taxation. I noted, however, in the staff report that the strengthening of tax administration and adequate preparation is required for the successful implementation of most of these reforms. I am wondering, therefore, if there is enough time and sufficient human resources to reorganize the administration and prepare it adequately. Moreover, while I am in full agreement with the measures to consolidate import taxation and to lower the "maximum all-inclusive rate" and at the same time reduce exemptions and concessions, I am wondering about the net results of those sweeping changes in tariff rates on public revenues. There are also doubts about the extent of economic activity this year as well. Last year, GDP increased by 4 percent while the forecast for this year is 6.6 percent, based on the assumption that there will be no external shocks. In case, however, of unforeseen contingencies, tax returns will be affected and the target reduction of the budget deficit will not be attained unless contingency measures have already been prepared. In that case, I would welcome some hints from the staff about specific measures designed for such a case. I noted, however, in Mr. Mirakhor's statement that despite heavy rains and some flooding, the cotton crop appears to be in good condition.

In the area of monetary policy, I welcome the rise in interest rates on the concessional loans. However, I find the percentage of concessional loans to total loans--which is now 31 percent--excessively high. I urge the authorities to reduce gradually these loans in a specified period of time.

In the area of external sector, I agree with the staff that the issue of the first sovereign Eurobonds goes beyond the funding that is raised. If the credit ratings from the rating agencies are satisfactory, it will establish a benchmark for subsequent private sector issues. Has the staff any information about the ratings from these agencies?

Finally, from the staff report and supplement, we note that all performance criteria for end-March and end-June have been met.

Some end-June indicative targets were missed but the relevant shortfalls were connected with the unfavorable developments in economic activity. I support, therefore, the proposed decision.

Mr. Blome made the following statement:

As I am in broad agreement with the staff appraisal and as this is the third discussion on Pakistan's economic policies within 12 months, I can be relatively brief. Progress under the ESAF and extended arrangements has so far been satisfactory, and the authorities are to be commended for keeping the program broadly on track, despite adverse developments such as the impact of the cotton virus. The envisaged policies for 1994-95 are also generally adequate in my view. I note, in this context, that the key economic indicators are expected to improve markedly in 1994-95. In addition, I welcome the fact that the authorities' strategy puts particular emphasis on further structural reforms in the fiscal area, where performance under previous programs has been weakest. Against this background, I have no problems in supporting the requested completion of the program review. Let me add a few remarks on specific policy issues.

Concerning fiscal policy, I welcome the targeting increase in the still-low tax, from 13.3 percent of GDP in 1993-94 to 16.7 percent in 1994-95. However, this relatively ambitious goal may be difficult to achieve in view of the existing public opposition against higher taxation and the still-existing weaknesses in tax administration as mentioned by Mr. Coumbis. In particular, delays could occur with respect to the envisaged extension of the General Sales Tax and broadening of the base of agricultural taxation. It may thus be advisable to formulate, in advance, additional contingency measures in order to safeguard the program against unexpected revenue shortfalls.

On monetary and exchange rate policies, I would first encourage the authorities to formulate a timetable for an early abolishment of the concessional credit schemes. Although the interest rates of these schemes have now been raised to slightly positive levels in real terms, they are still not market-oriented and continue to contribute to distortions in the financial markets. The fact that government-directed credits amounted to nearly one third of total domestic credits in mid-1993 is another cause for concern in this regard.

The authorities should also consider announcing an explicit exchange rate target in order to provide monetary policy with a nominal anchor. External competitiveness seems to be adequate at the current exchange rate, as the strong growth of nontraditional exports, the relatively low real effective exchange rate, and the declining inflation differentials vis-à-vis major trading partners underline. The floating rupee-dollar rate has already been quite stable at around PRs 30 per US$1 since mid 1993, which seems to indicate that the transition to a more stable exchange rate regime would not be too difficult.

Finally, one comment on structural reform and trade policy. Although the authorities have taken some steps aimed at a simplification of the import taxation system and at lowering rates, I have the impression that the tariff system continues to be complex and the degree of protection seems to remain high with maximum rates of around 70 percent and even higher tariffs for some items such as cars. The authorities should thus consider accelerating the reform process in this area. I welcome, in this context, the fact that the staff and the authorities will analyze in detail the latest developments in trade policy in the framework of the forthcoming discussions on a second annual ESAF arrangement. This will provide us with the opportunity to have a closer look at trade policy issues in the next Board discussion on Pakistan.

The staff representative from the Middle Eastern Department reported that fiscal adjustment and reform were at the heart of the Pakistan program; this had two aspects--quantitative and structural. In light of Pakistan's past experience of repeatedly introducing ad hoc fiscal measures the impact of which was subsequently eroded, it was considered important to include deep structural reform measures in the program. That posed an important challenge on the tax administration front. The structural changes in indirect taxation--especially the broadening of the General Sales Tax--and indirect taxation--in particular, income taxes--were quite substantial. To ensure the sustainability of those changes, certain steps were being taken. First, the program had been designed in a sequential manner, with clearly targeted technical assistance being provided by the Fund, the Bank, and bilateral creditors, in particular, the United Kingdom. Second, steps had also been taken to strengthen personnel and computerization. The next phase of broadening the General Sales Tax would be in the retail sector, and steps were being taken to ensure that the administrative capacity was in place by July 1, 1995, when the new General Sales Tax in that sector was to come into effect.

The program aimed for a reduction in the maximum import tariff over a three-year period from 92 percent to 35 percent, the staff representative observed. The extent of revenue losses would depend on concurrent progress in reducing widespread exemptions and concessions, as well as on the impact of the decrease in tariffs on smuggling, which escaped taxation.

Nevertheless, there would be revenue losses associated with the new import tariff regime. Hence, the staff had emphasized the importance of broadening the General Sales Tax and widening the income tax net. Progress in those areas was critical for sustaining the reforms on the revenue side.

In view of the uncertainties the program confronted relating in particular to the impact of the widespread structural changes, the authorities had identified contingency measures, the staff representative stated. Those measures related to adjustments in administered prices and in noncore investment expenditures.

The authorities were considering floating Pakistan's first Eurobond issue--in the amount of $200 million--to establish access to international capital markets, the staff representative from the Middle Eastern Department explained. That was a means also of enhancing the availability of non-debt-creating flows, improving the maturity structure of the outstanding debt, reducing the cost of borrowing, and reducing the vulnerability of the external accounts. To prepare for the Eurobond issue, the authorities had requested ratings from the two major credit rating agencies--Standard & Poor's and Moody's. Both agencies had completed their work, and the ratings were expected shortly. The ratings had been requested because the authorities believed that an independent and market-credible assessment of country risk would facilitate the Eurobond issue, and in some industrial countries, institutional investors were prohibited from investing in instruments that did not carry credit ratings from major agencies. Thus, it was hoped that the market for the Eurobond issue would be broadened. The Eurobond floatation would provide the market's regular assessment of Pakistan's sovereign risk, which was important for the Pakistan private sector as it sought access to international capital markets. The Eurobond would thus act as a benchmark for private sector investors. Those same considerations would play a role in facilitating the privatization of large utilities, such as the telecommunication company, for which the authorities intended to tap international equity funds.

Ms. Brettschneider made the following statement:

> I have little to add to the staff report, other than to join others in commending Pakistan's strong performance under the first annual ESAF arrangement thus far and encouraging further progress. While growth and price stability did not improve as much as hoped--owing in large part to exogenous factors--the authorities' diligence in tightening financial policies and continuing structural reforms is paying off. The significant decline in the fiscal deficit, the strengthening of the reserve position, and increased confidence on the part of domestic and international investors illustrate clearly that the economy is responding well to the program. We share Mr. Dorrington's view, however, that there is no room for relaxation. The authorities must sustain the momentum of their budgetary tightening and reform efforts to

ensure continued improvement in Pakistan's economic and financial position.

I can support the proposed decision.

Assuming that all the performance criteria under the program were achieved, I agree with Mr. Autheman and Mr. Al-Jasser that this midterm review could have been completed on a lapse of time basis in line with the agreed informal guidelines. Although I recognize that some Directors may have bilateral concerns they wish to raise, I wonder whether another means could be found other than a full Board discussion to incorporate individual issues into the record in cases such as Pakistan's. One possibility would be a memo circulated to Directors that could then be included in the record.

Mr. Wang said that he agreed with Mr. Autheman and other Directors that the Pakistan economy had performed well under the ESAF and extended arrangements. The program was comprehensive, coordinated--even ambitious--and tailored to meet the country's specific circumstances. As a result of the authorities' firm commitment to the program, all the performance criteria and benchmarks had been met. Particularly impressive were the acceptance of the obligations of Article VIII and the accumulation of international reserves to a comfortable level. Those steps would provide assurances on Pakistan's ability to meet its bilateral and multilateral debt obligations. Based on the past record of the Pakistan authorities, his chair was confident that they would be able successfully to complete the program. Thus, he could support the proposed decisions.

Mr. Ismael made the following statement:

I am pleased to note that Pakistan's economy has performed well and that all the performance criteria under the ESAF and extended arrangements have all been met.

Since Pakistan's economic situation has been very comprehensively discussed only in February this year, I will now confine my comments to the exchange rate policy pursued by the authorities. The exchange rate policy is aimed at striking an appropriate balance between maintenance of external competitiveness and monetary stability. Such an objective is not easily achieved.

Nominal depreciation as an instrument to improve competitiveness will put an upward pressure on prices, while the authorities are already faced with a frustratingly difficult task of getting the headline inflation rate down. As the growth in nontraditional exports continues to be buoyant, there is no urgent need to use depreciation as an instrument to improve competitiveness. A better alternative would be to intensify ongoing deregulation and liberalization efforts to cut costs and achieve improved efficiency of the economy.

The priority, therefore, is for a fixed but adjustable exchange rate system. Such a system will necessarily better impart the much-needed fiscal and monetary discipline consistent with the authorities' commitment to a macroeconomic strategy aimed at fiscal consolidation and price stability. The staff's comment will be much appreciated on this matter.

In conclusion, I welcome Pakistan's acceptance of the obligations of Article VIII last July, a status all member countries should strive to attain. I also support the proposed decisions.

Ms. Laframboise commended the authorities for their perseverance and performance under the program. She agreed with Mr. Autheman that the review should have been concluded on a lapse of time basis. She also agreed with Ms. Brettschneider on the possible ways to resolve bilateral issues. The program was extremely good, and her chair looked forward to its successful completion.

At the previous Board discussion on Pakistan, her chair had voiced concern about two areas--fiscal performance and political commitment--Ms. Laframboise recalled. She was pleased to note that neither of the two areas had posed serious obstacles to the authorities' overall adherence to the program. Nevertheless, her chair agreed with Mr. Dorrington that the 1994-95 fiscal deficit target of 4 percent of GDP, although achievable, had not yet been met, and, hence, the authorities should be ready to take additional measures if necessary. She could support the proposed decisions.

Mr. van der Kaaij stated that he endorsed the thrust of Mr. Dorrington's statement. One of the challenges for the authorities in the future would be how to handle capital inflows without jeopardizing their achievements. He hoped that the authorities had taken note of the recent World Economic Outlook. Owing to the development of the financial markets, the use of indirect monetary instruments, and the improvement in the structure of the budget, the authorities had added appropriate weapons to their arsenal, thereby enabling them to respond to the capital inflows.

The staff representative from the Middle Eastern Department commented that the authorities had maintained a relatively stable nominal rate since the devaluation in July. Issues related to the exchange rate, as well as the sources and uses of capital inflows, would be on the agenda of the forthcoming October-November discussions.

Mr. Mirakhor, observed that, in view of the Board's heavy schedule, the review could have been handled on a lapse of time basis. Some Directors had referred to the informal procedures for settling bilateral matters. One method was that the chair concerned would be informed of the nature of the query. He had not been informed beforehand by the Russian chair of its request to the Executive Board to hold the current meeting. Had he been informed, the issue might have been resolved on a bilateral basis.

The Russian chair assumed that the Pakistan authorities might request a renegotiation of the 1994 debt, Mr. Mirakhor considered. It seemed that the request for a debt renegotiation was being interpreted as a request for debt reduction, which would have had to have been made to all creditors. Pakistan had fulfilled its debt obligations to all international creditors. The Russian chair might consider treating all debtors uniformly, because the issue of debt to Russia had arisen on an earlier occasion--in the case of Algeria--and would probably resurface in the future. The fact was that ruble-denominated assets had declined in value, and questions that arose bilaterally required bilateral consideration. On behalf of his Pakistan authorities, he wished to thank the Saudi Fund for Development for the ESAF-associated loan of SDR 30 million.

Mr. Mozhin explained that his authorities were concerned about the issue of Pakistan's debt; hence, the request for a Board meeting. He regretted that Mr. Mirakhor had not been informed in advance about his chair's proposal to hold a meeting, and on the nature of the query.

Mr. Dorrington remarked that the issue of procedures raised at the meeting was an example of the kinds of issues that should be discussed at the informal meeting of Directors to discuss Board procedures, which was to be chaired by Mr. Kafka and scheduled for after the Annual Meeting. He regretted that there was not much support for the meeting on Board procedures.

The Executive Board took the following decisions:

<u>ESAF and Extended Arrangements - Review</u>

1. Pakistan has consulted with the Fund in accordance with paragraph 2(d) of the first annual arrangement under the enhanced structural adjustment facility, paragraph 3(c) of the extended arrangement (EBS/94/9, Sup. 3, 2/28/94), and paragraph 45 of the Memorandum on Economic Policies attached to the letter dated December 26, 1993 from the Advisor to the Prime Minister on Finance and Economic Affairs and the Governor, State Bank of Pakistan.

2. The letter from the Advisor to the Prime Minister on Finance and Economic Affairs and the Governor, State Bank of Pakistan dated August 9, 1994, with the attached Memorandum on Economic Policies, shall be attached to the first annual arrangement under the ESAF and the extended arrangement, and the letter of December 26, 1993 and attached memorandum shall be read as supplemented and modified by the letter dated August 9, 1994.

3. Accordingly, the first annual arrangement under the ESAF shall be amended by adding the following sentence at the end of paragraph 1(a):

The equivalent of up to SDR 30 million to be financed from the Enhanced Structural Adjustment Facility Trust may be financed instead under an associated loan from the Saudi Fund for Development (SFD) to Pakistan, to be disbursed through the SFD Special Account established by Executive Board Decision No. 9060-(89/5) ESAF, adopted January 18, 1989.

4. The limits and floor specified in paragraph 3(a) of the extended arrangement shall be amended as specified in paragraph 24 of the Memorandum on Economic Policies attached to the letter of August 9, 1994 and Table 1 attached thereto.

5. The Fund determines that the midterm review specified in paragraph 2(d) of the first annual arrangement under the ESAF, and the review specified in paragraph 3(c) of the extended arrangement have been completed, and that Pakistan may proceed to request the disbursement of the second loan under the first annual arrangement under the ESAF.

Decision No. 10780-(94/82), adopted
September 9, 1994

Exchange System

Pakistan maintains a multiple currency practice arising from the remaining forward exchange cover contracts which are subject to approval under Article VIII, Sections 2(a) and 3. The Fund notes that the multiple currency practice will automatically be eliminated upon expiration of these contracts and grants approval for the retention of the multiple currency practice until May 31, 1995.

Decision No. 10781-(94/82), adopted
September 9, 1994

2. DEVELOPING COUNTRIES - FINANCING AND DEBT SITUATION

Executive Directors considered a staff paper on financing for developing countries and their debt situation (EBS/94/167, 8/23/94). They also had before them papers on private market financing for developing countries (SM/94/224, 8/17/94), developments and prospects in officially supported export credits (SM/94/230, 8/26/94), and official financing for developing countries (SM/94/237, 9/1/94).

Mr. Havrylyshyn made the following statement:

The staff has presented insightful and extensive documentation on the current situation concerning the financing for and debt of developing countries. A general question that comes to mind while studying this subject is which lessons the Board and management should draw from the staff's analyses, and thus, what policy implications they should have for our work. I hope that the current Board discussion will shed further light on this, and that the staff can summarize what it views as the most important lessons.

I agree with the staff that the general thrust of the debt strategy has proved to be appropriate, and that progress toward resolving the commercial bank debt problems of middle-income countries continues. Countries pursuing stringent and balanced adjustment policies are rewarded for their efforts by increased private capital inflows and export credit financing. The group of heavily indebted countries has shown substantial GDP growth over the last several years, which occurred despite the general recession in the OECD area. In the meantime, net debtor countries managed to reduce their ratios of debt to export.

In spite of the above-mentioned favorable developments, it is important to keep several points in mind. Bond financing has increased considerably, and has become the principal means of private debt financing for developing countries, although a growing share of capital inflows nowadays consists of non-debt-creating direct investment. Apparently, the ample availability of capital has facilitated a surge in imports that resulted in increasing and sometimes unsustainable current account deficits. As long as capital continues to flow in, this does not cause any material difficulties.

However, the volatility of capital flows has increased, which implies that sudden financing problems might reappear, primarily for those countries for which the continuation of capital inflows may be in question because of a deterioration in macroeconomic balances that is uncorrected by adequate policies. Indications for that can be found in the fact that countries sometimes profit from an improved perception of the debt situation in the region where they are located. Markets may have second thoughts, which occurred in early 1994. Their delayed reaction may prove to be severe.

A country may be affected adversely by a deterioration in the situation of a neighboring country. Developing countries profited from the fact that investment in developing countries proved to be a suitable way to diversify portfolios of investors in the OECD area. However, this comparative advantage has leveled off during the recent turmoil on the international financial markets, as the staff explains on page 21. This illustrates once more the risks of volatility of capital flows for developing countries.

The obvious policy conclusion of all this is that debtor countries should continue pursuing strong adjustment policies in order to prevent heavy reliance on capital inflows. In addition, as the staff rightly states on page 22, a careful monitoring of external borrowing by the authorities remains essential.

I fully endorse the opinion of the staff that debt forgiveness by the multilateral institutions is to be rejected. The staff is quite right in pointing out that moves toward debt forgiveness by multilateral institutions would threaten not only the provision of new financing from the institutions and the associated policy advice, but also financing flows from other creditors and donors that rely on the policy framework provided by the institutions.

Multilateral institutions now hold a great part of the public external debt of low-income countries--over 40 percent--and thus a large part of total external debt. For the countries themselves, this implies that room for debt relief is to a certain extent limited. It implies that the multilateral institutions are having to carry a larger part of the risk of being financially involved in these countries. The private sector can choose to walk away from the low-income countries, and the creditor countries have shown an increasing preference to burden the multilateral institutions rather than their own budgets with extending financial support.

Two important observations can be made from this development. Creditor countries must realize that they themselves are part of the multilateral institutions. For the creditor countries to burden the multilateral institutions with the costs and the risks of financing low-income countries only means eventually a redistribution of the costs in time, and between budget items.

The tendency of increasing holdings of debt by the multilateral institutions has the following policy implication: there should be a tendency to increase conditionality. It becomes even more important to demand the implementation of effective adjustment policies from the low-income countries, preferably in the context of a Fund-supported program. Extensive adjustment is the only guarantee for ultimately recovering the financial resources provided by multilateral institutions, and thus for reducing the risk for multilateral institutions of their increasing share in total exposure to these countries. Moreover, strong adjustment policies could improve the prospects for increased official development assistance by the donor community, the prospects for debt relief by means of stock-of-debt operations envisaged by the Paris Club, and the prospects for successful debt negotiations with commercial banks.

Escrow accounts and waivers of negative pledge clauses should be used only in extraordinary circumstances. A proliferation of these ways of securitization would reduce access to unsecuritized lending, and thus would delay a normalization of relations between debtors and creditors. Moreover, it would endanger the preferred creditor status of the multilateral institutions.

Debt problems remain very difficult for the low-income rescheduling countries. The approach to debt restructuring established by the Paris Club has allowed progress to be made in dealing with the debt problems of countries that reinforced their adjustment efforts. I agree with the staff that debt-stock operations are appropriate for such countries. I support the differentiated approach followed by the staff in these matters: debt reduction should be carried out in a way that takes into account the specific circumstances and needs of the debtor countries involved. The staff rightly observed that, although new financing has greatly exceeded actual debt service, official development assistance is declining, while export credit growth is likely to continue, and that in these circumstances, policy performance is increasingly becoming the most important determinant of countries' access to financing from all sources.

Mr. Dorrington made the following statement:

We have become accustomed to seeing excellent papers on this subject each year. If anything, this year's papers are even better than last. I agree with the great majority of the conclusions set out in the final section of the main report.

I agree with the staff's analysis that the difficulties of middle-income debtors are now much more manageable than before, but there is no room for complacency. These countries are relying increasingly on private finance, which can be a volatile source of finance. This reinforces the need for them to maintain a strong credible domestic policy framework--and not to resort to counterproductive capital controls.

It is important that middle-income countries do genuinely graduate from Paris Club reschedulings. Some seem reluctant to do so, despite their lack of a clear balance of payments need for rescheduling. They need to take account of the paper's self-evident but nevertheless important conclusion that rescheduling affects the availability of financing, including new export credit cover.

Debt problems remain for some of the poorest countries, notwithstanding the clear message from Chart 2 (page 14a) that new financial flows have in most cases far exceeded debt-service payments. I agree with the paper on the importance of stock-of-debt reductions. Indeed, the United Kingdom has consistently pressed for full implementation of the Trinidad and Tobago terms, and I was pleased to see the outcome of the Naples G-7 summit, which urged the Paris Club to implement "stock-of-debt reductions and to increase the level of concessionality for countries facing special difficulties." The United Kingdom is pressing for immediate stock-of-debt reductions for those countries that have a record of performing satisfactorily under Fund-supported programs and under Paris Club agreements, with up to 80 percent debt reduction for the poorest, most indebted countries. This should produce an exit rescheduling consistent with a sound policy framework over the medium term. It is important that the limited volume of concessional aid should be targeted primarily at low income countries, in order to assist them with necessary adjustment and institutional reforms. I therefore endorse the view that the Helsinki disciplines on mixed credits should be applied rigorously in order to free scarce aid for the poorest countries.

I welcome the analysis set out in these papers of the effects of debt reduction. The World Bank methodology toward resolving the problems of severely indebted low-income countries is very relevant to stock-of-debt reductions, as it considers all debt-service on a net present value basis compared to exports, and thus also takes account of the concessionality of loans. Flow analysis has shortcomings if debt is long term.

It would help if the Fund and the World Bank could agree a consistent line on which countries need a debt stock treatment. I understand that at the Geneva debt conference in May, it was clear that the World Bank thought that more countries needed a debt stock reduction that the Fund did.

There are a handful of severely indebted low-income countries for which a reduction in the stock of debt under a Paris Club agreement will not make sufficient inroads into future debt-service obligations to achieve a sustainable external position. These often have high indebtedness to international financial institutions. The role of the Fund is to help all members to achieve external viability. This is particularly difficult for severely indebted low-income countries, even those that follow appropriate policies; we should pay particular attention to these countries, especially those heavily indebted to the Fund itself, and examine new ways in which we can assist. The G-7 countries agreed at Naples that international financial institutions should find ways to mobilize more effectively their resources to help, among others, the "poorest, most indebted countries."

Of course, the Fund already does a great deal directly, both through the provision of resources under the enhanced structural adjustment facility (ESAF) and through policy advice and technical assistance, and indirectly, by catalyzing support from others. We should always be looking for ways of utilizing all the resources of the Fund in the way that is most effective. Of course, we must recognize that these resources are not unlimited, and we should not violate the monetary character of the Fund. Let me be clear that I am not calling for write-offs by the Fund or other international financial institutions.

My authorities do not fully share the Fund's concerns about proliferation of escrow accounts. A key difficulty for transition economies trying to attract finance for viable incremental investment is the fact that so many assets are in the public sector. In less centrally planned economies, such assets would be in the private sector, and would not affect the Government's ability to service its debt. The key is ensuring viable, incremental investment, which should improve a country's ability to service its debts.

Ms. Srejber made the following statement:

The framework for dealing with the debt difficulties of middle-income countries produces quite satisfactory results. I thus agree with the staff that the strategy should be continued.

As I also agree with the staff on the other main conclusions and recommendations, I would just like to stress some points that I feel are crucial for the successful future treatment of the problems still remaining.

There are certain lower middle-income countries, and most of the low-income countries, that still face a very difficult external financial situation. The main part of the work to alleviate the severe problems in these countries has to be done by the countries themselves, as the main element in an appropriate strategy is a convincing and sound economic policy. This, combined with a comprehensive debt package, would limit uncertainty about economic prospects, which, in turn, would encourage further financing. For a large number of low-income countries, debt stock operations, with an appropriate level of debt or debt-service reduction, are obviously needed, as pointed out to the Paris Club by the G-7 leaders at the summit in Naples. I concur with the staff that there is a strong case for early debt stock restructurings for countries with a good performance record under Fund-supported programs.

The commercial banks should continue to play their part in the effort to find a durable solution to the debt problems. The increased flexibility in some of the recently concluded bank debt restructurings in adapting the design of the packages to individual country circumstances, giving the countries more certainty with regard to up-front costs and the profile of the debt service relief, is positive. I also agree with the staff that commercial banks may need to show additional flexibility, both in terms of design and financing of debt operations, to address the commercial debt problem of some low-income countries.

The staff makes a good analysis of export credit financing, with which I fully agree. Export credits should not be used too extensively in the overall financing of developing countries, and particularly not for countries that require large net financing for prolonged periods, as these credits are linked to new imports of specific products, and are short term in nature. Export credits can even limit use of some better-suited balance of payments support. Neither for developing countries nor for countries in transition could export credits substitute for balance of payments support.

I fully join the staff's view as it presents convincing arguments against debt forgiveness by the multilateral institutions, and by the Fund in particular. It is essential that these institutions, in particular the Fund and the Bank, continue their central role of providing not only financing but, in particular, policy advice to developing countries, and of catalyzing financial support from the international community. As the staff points out, multilateral debt forgiveness would be detrimental to these efforts and undermine the present debt strategy. For the Fund, debt forgiveness would pose serious dangers to the institution's monetary character and the revolving nature of its resources.

Mr. Sirat made the following statement:

I would like first to commend the staff for this very informative set of papers on nearly all aspects of financing for developing countries.

I welcome the conclusion and beginning of implementation of major commercial bank debt restructuring deals, notably with Brazil and Poland. By and large, the main aspects of the strategy for commercial bank debt restructuring have proved to be effective. This effectiveness will be enhanced by our recent decision on fungibility, as mentioned by the staff on page 4.

Nevertheless, some countries continue to have a relatively large commercial bank debt stock and a crucial need for restructuring. I have in mind in particular countries that are IDA-eligible or ESAF-eligible and which are heavily indebted to commercial banks. The staff paper gives two examples of such countries: Nicaragua and Côte d'Ivoire. I wonder whether the staff could go beyond what is said in the paper about the possibility of effectively financing possible debt restructuring agreements.

As mentioned in the paper, the only option currently available under our existing debt strategy would be to promote a debt buy-back supported by the IDA facility, but such an operation could not be significantly financed by this mechanism, given the existing constraints on the facility's resources and the size of the debt concerned. Moreover, a mere buy-back might not be appropriate for countries that would need to renew long-term relationships with commercial banks at a later stage of their adjustment.

The paper mentions the possibility of expanding the options available in the menu, by including in it deep-discount bonds, for example; that is certainly worth exploring. In addition, I wonder whether we should not address again our support strategy for those countries, by making available more explicitly our financial mechanism of set-asides and additional resources to ESAF-eligible countries. I would appreciate comments from the staff on this.

Regarding private financing flows to developing countries, the staff's comments on page 22 may raise worrying doubts as to the seniority of bonds and the private nature of bonds issued by the private sector. I wonder whether the staff could elaborate on those comments, which might create false perceptions on the part of both potential investors and private issuers. I note that bilateral creditors in the framework of the Paris Club acknowledge, de facto, the seniority of bonds in their rescheduling decisions. Clearly, as the share of bonds increases, and as a larger portion of the debt becomes nonreschedulable--that is, multilateral, post-cutoff date debt bonds--the question of the possibility of effectively protecting all these claims cannot be avoided. I am not sure there is any clear-cut answer to this difficult question. Also, the idea of a possible bailout of private sector issuers seems particularly devastating, and the Fund should certainly argue strongly against it.

The staff paper clearly illustrates the difficulties of articulating two sets of objectives for officially supported export credits. There is the objective of ensuring a fair degree of concurrence among exporters--which implies laying the ground rules for export credit agencies--and the objective of limiting systemic risks, which arises from the fact that all export credit agencies would, in effect, apply the same rules about the type and duration of credit--leading to possible "humps" in the country's repayment schedule--or about a decision to go off-cover. There is also the objective of developing exports--and ensuring that financing is available for that--to a given country, possibly through risk-free techniques such as escrow accounts, with the aim of keeping maximum flexibility in the management of foreign exchange. From this point of view, while the use of an escrow account for a specific project might be justified, there is no doubt that a multiplicity of such accounts would create a systemic risk: at the limit, if 100 percent of export receipts were to be set aside in escrow accounts, such accounts would be useless.

France regrets the reduction in flows of official development assistance last year, and continues to resist this temptation in spite of its budgetary constraints. This being said, the staff's remarks about increasing budgetary strains in most donor and creditor countries are well taken, and of great importance. These remarks should be borne in mind in tackling the issues of multilateral debt and stock-of-debt operations for the poorest countries.

It is likely that the development of stock-of-debt operations would lead to a greater involvement of consultative groups in the financing of the developing countries concerned, as bilateral flows of a longer duration would be required, which would accordingly increase the budgetary burden on the industrial countries of financing the developing countries.

This subject is linked to the issue of the importance of the existing stock of developing country debt to multilateral institutions. The paper is somewhat off the mark in concentrating on the issue of debt forgiveness, which is just not possible. The real question seems to be the refinancing by multilateral institutions of their existing claims--that is, with appropriate new multilateral money.

As illustrated by Table 6 on page 20 of the background paper (SM/94/237), the multilateral institutions have played this role over the last five years, by keeping net flows of resources positive to low-income countries in particular. They should certainly continue to do so at least until those countries' financing gaps can be reduced, in particular by setting in place lending policies that put countries in a position to increase their net repayments to the multilateral institutions. From this point of view, it is not clear why the Fund should reduce access to ESAF resources for countries that request access to the ESAF a second time, as we mentioned recently in connection with Senegal and Uganda. Put another way, it seems doubtful whether bilateral creditors should--or could--refinance in general the multilateral institutions, given the budgetary constraints on the bilateral donors and the probable impact of stock-of-debt operations.

Regarding Paris Club issues, in particular with respect to low-income countries, I find the background papers very interesting, and I am sure that they would be of great value to the Paris Club Secretariat in the technical discussions that should take place soon on the issue of stock-of-debt operations for low-income countries. Naturally, it should be kept in mind that it is still too early to judge what the outcome of these discussions will be or whether a new consensus will emerge among the bilateral creditors, even though the Naples communiqué should encourage rapid progress--progress that France certainly favors.

Concerning the most appropriate indicator of indebtedness, I understand all the staff's arguments against using a stock-of-debt ratio, even in net present value terms, to assess the effective debt problem of a country, because a debt problem is primarily a liquidity problem. At the same time, I have some sympathy for using a stock-of-debt ratio to assess the impact of a stock-of-debt operation, as the main argument in favor of stock-of-debt operations is that they provide a mechanism for exiting the reschedulings process and for reducing the debt overhang, as measured by the stock-of-debt ratio to exports or to GDP. There is some logic in using stock-of-debt criteria to assess whether or not a stock-of-debt operation would be warranted.

I am therefore not sure that debt-service ratios as used by the staff in the background paper clearly illustrate the impact of a stock-of-debt operation, because those ratios would be modified in exactly the same way, through the rescheduling of debt flows. I therefore find Tables 3-9 of the background paper misleading, as they compare apples and oranges. Indeed, the baseline scenario mentioned in these Tables does not encompass any rescheduling of flows, and it therefore cannot be compared with a scenario encompassing a stock-of-debt rescheduling.

In summary, therefore, in comparing debt-service ratios on a flow basis, the rescheduling of flows has proved to be rather generous, with better cash flow effects than an equivalent stock-of-debt rescheduling would have. In comparing debt-service ratios on a stock basis, with the debt stock as a proportion of exports or GDP, a stock-of-debt operation is evidently more generous.

I would also suggest that it may be misleading to say that the rescheduling of debt flows is by nature an exceptional kind of financing, while regular consultative group procedures, or a stock-of-debt operation, should be considered as normal financing. The protection of new credits from any rescheduling--through the maintenance of the cutoff date--in fact limits the exceptional nature of reschedulings, especially as in many cases, a Fund agreement leads both to a Paris Club rescheduling and to renewed bilateral flows. In a way, the differentiation between new bilateral flows and the rescheduling of flows is rather artificial; bilateral creditors and donors use both as a matter of course to support a country with balance of payments problems.

Accordingly, it is difficult to say that a stock-of-debt operation is by nature better than a rescheduling of flows, let alone the unique solution to debt problems faced by all low-income countries. From this perspective, the staff is right to stress that a stock-of-debt operation would generally not permit in itself the attainment of medium-term balance of payments viability. A large transfer of resources from all sources would still be needed to achieve that. A stock-of-debt operation is certainly justified when it can provide an exit from the rescheduling process.

It is difficult to assess before the fact the viability of such an operation, as assumptions need to be made about the medium-term balance of payments projections. In that connection, some may find the staff's export assumptions to be on the optimistic side. Also, the authorities' long-term commitment to reform and an adjustment program need to be assessed.

My authorities hope that Paris Club creditors will soon be in a position to sustain their progress on debt issues both with respect to operations that lead to exiting from the rescheduling process and, when warranted, the rescheduling of debt flows, possibly involving greater concessionality.

Mr. Dorrington commented that, in light of the overall policy on access, he wondered whether Mr. Sirat was suggesting that pre-existing use of the ESAF, or access to other types of Fund resources, should not be taken into account in determining access under a forthcoming ESAF arrangement. He would tend to disagree with such an argument. At the same time, he could agree with Mr. Sirat that the amount of access should be determined on a case-by-case basis, in the light of the circumstances of individual countries.

Mr. Sirat explained that with the coming potential to effect stock-of-debt reduction operations for low-income countries, multilateral institutions' share of the total stock of debt of low-income countries would automatically increase, but that should not be a reason for them to reduce the level of new disbursements. It was also important to bear in mind the fact that it was taking more time than expected for reforms to take hold and bear fruit in less developed countries and the economies in transition. Countries that requested access to the ESAF for a second time should not necessarily have a lower level of access to the ESAF than they had at the time of their first ESAF arrangement. The fact that a country's credit outstanding under a current ESAF arrangement was large should not mean that its access under another ESAF arrangement must be reduced.

Ms. Srejber asked Mr. Sirat to explain what he meant when he said that it seemed extremely doubtful that bilateral creditors could or should generally refinance multilateral institutions.

Mr. Sirat replied that the staff paper had not implied that bilateral creditors should refinance multilateral institutions. Some countries had large stocks of debt owed to multilateral institutions, the fact of which was sometimes used as a defense of a reduction in the involvement of the multilateral institutions in those countries--often, the poorest countries. He did not believe that that was an appropriate argument. The multilateral institutions should not flee from the poorest countries in the footsteps of private market participants, leaving only the bilateral donors and creditors behind.

Mr. Cserés made the following statement:

The main implications of this year's review of the financing and debt situation of the developing countries are basically unchanged since the last review. The middle-income countries have made remarkable progress with their debt situation, with just a few exceptions in the form of some countries that continue to face serious debt problems. This outcome would have been impossible without the macroeconomic improvement achieved through the debtor countries' pursuit of appropriate financial and structural policies. In contrast, the debt situation of many low-income countries and a fair number of lower middle-income rescheduling countries remains very difficult, even though some of those countries have made a determined effort to adjust. In addition, most transition countries, especially the countries of the former Soviet Union, are still experiencing serious external financing difficulties.

The staff's treatment of the difficult and important debt issue is as clear and thorough as usual, but on this occasion, it may paint a somewhat overoptimistic picture. While recent years have seen encouraging progress in many areas, the debt problems of the developing countries remain unsolved. Although these problems no longer directly threaten the international financial system, the overhang is still a heavy burden. For some countries, indeed, the debt problem stands in the way of external viability and undermines their adjustment efforts. The situation is perhaps at its most serious, and most worrisome, in the low-income countries of sub-Saharan Africa.

The annals of uneven policy implementation show that shaky prospects for external viability often undermine a country's adjustment efforts and obstruct a decisive improvement in its economic situation. Assistance and support from the international financial community is especially needed, as the staff notes, because in small economies, an amount of debt arrears that is small in comparison with the debt of the large middle-income debtor countries is often inordinately burdensome. For these countries, even modest additional support can provide large benefits in terms of adding momentum to the domestic adjustment process. Recognizing the special situation of these countries is an important step in finding the financial solutions that will provide them with appropriate relief, thus enabling them to escape the trap of perpetual rescheduling. Of course, the widely differing situations of countries requires a case-by-case approach to debt problems, but in most cases, the solution will involve a reinforcement of the adjustment effort.

Unfortunately, there are even shadows on the brighter picture of countries that have succeeded in addressing their immediate debt and financial problems. Their success does not necessarily mean that the debt crisis is for them ended forever.

Despite the encouraging progress the middle-income countries have made in their debt problems, their debt indicators are still high, and the threat of renewed debt-service problems has not disappeared completely. For these countries, nothing is more important than sustained economic policy implementation, which will provide their economies with the resilience needed to respond to negative external shifts, and to prevent potentially large net capital inflows from endangering their stabilization programs.

Those middle-income countries that have dealt successfully with their debt problems have graduated eventually from heavy reliance on exceptional financing, and have regained access to new private and official flows. At the same time, however, the opening of their economies and their greater integration into the world economy has made them more vulnerable to the international environment, and no amount of domestic adjustment can overcome a lack of access to industrial country markets, or the absence of demand in those markets.

Concerning the specific role of the multilateral institutions, and of the Fund in particular, it is obvious that the multilateral institutions have borne a steadily increasing share of the financing of developing countries, and they will probably continue to be one of the few sources of finance for low-income developing countries and most of the economies in transition. This is why we argued for extending the life of the systemic transformation facility by one year, and supported the idea of raising the access limits under stand-by and extended arrangements.

The Fund's role in developing country financing is unique in that it is the only multilateral institution that is a monetary--as opposed to a developmental--institution. The pattern of purchases and repurchases of the Fund's operations differs greatly from the operating modalities of the other multilateral institutions, and the Fund must continue to place great emphasis on its conditionality.

Under any future approach to solving the global debt problem, the Fund should retain its central role in the complex financial diplomacy governing the relationships between debtors and creditors. At the same time, it must steer a careful course: either increasing the Fund's financial exposure much beyond present levels, or relaxing its conditionality, would endanger both the institution and the debtor countries. The Fund could usefully become more deeply involved in seeking mechanisms to mobilize resources in ways that would establish earlier, closer, and more effective coordination between debtors and creditors. The Fund could also help to improve information flows by acting as a coordinator and distributor of information, in conjunction with its regular surveillance activity. A role for the Fund in promoting capital account convertibility would also help increase financial flows to developing countries.

Most economies in transition rely heavily on official sources of finance. Some, however, have no major source of funds at present other than bond issues in the capital markets, as the commercial banks have cut back their long-term lending to them, or have structured it around instruments designed to protect them from country transfer risk. For the time being, most of these countries will find it preferable to seek funds through foreign direct investment, which can provide them with much more than simple financing. An analytical study of the role of foreign direct and portfolio investment in transition economies, and the effects of such investments on those countries, would help them to plan wisely in meeting their future financial needs.

Officially supported export credits are expected to play an ever increasing role in assisting the economies in transition. At the same time, the paper clearly shows the limitations and disadvantages of this type of support. During last year's discussion, several Directors called for greater flexibility and transparency, especially with respect to the escrow accounts. It would be interesting to know what actions have been taken to that end.

Mr. Torres made the following statement:

The four staff papers for today's discussion give us a comprehensive picture of the current status and main trends in financing for developing countries and their debt situation. It is encouraging to conclude from those papers that significant progress continues to be made in both financing flows to developing countries and debt alleviation. It is also encouraging that the Fund, among other multilateral institutions, has played an important role in these developments.

The main lesson to be drawn from this is that an appropriate mixture of sound economic policies and external debt alleviation is the most effective way to attain sustainable growth. This lesson makes us agree fully with the staff that there is a strong need for stock-of-debt reduction for those heavily indebted countries that are undertaking comprehensive and sound economic reform programs. There is a risk that if debt relief does not come in time, the whole adjustment program may fail, with the high costs then associated with starting all over again.

The empirical evidence of recent years causes us to agree with the staff that the current framework for dealing with bank debt problems has proven to be adequate. Now, we may be even more optimistic, as world economic prospects look better today than they have in previous years.

However, a cause for concern is that there is still a number of countries with large amounts of commercial debt that need to be restructured. Nicaragua and Côte d'Ivoire are mentioned in the staff paper as examples of this. Under the current debt strategy, the options for these countries--such as the buy-back--are very difficult indeed.

It is clear from the staff paper that multilateral institutions have increased substantially their share of the financing of developing countries. The recent extension of the systemic transformation facility and the increase in the access limits under stand-by and extended arrangements have been part of it. I have no doubt that multilateral institutions are serving their general objectives well by doing that. I also agree with the staff that debt forgiveness should be avoided. The arguments given by the staff and some other Directors against debt forgiveness are solid enough and do not need much reinforcement.

However, there is a need to explore new ways of utilizing all Fund resources to help the poorest and most indebted countries to achieve a viable external position, which is at the heart of the Fund's objectives. The revision of the financial mechanisms for set-asides may be an example.

The increasing role of multilateral institutions in holding of debt will increase conditionality. As conditionality is nothing more or less than sound economic policy, the increased role of multilateral institutions might be interpreted as a means by which economic recovery and the capacity to repay is better guaranteed. As the prospects for economic recovery improve, other creditors should be willing to extend further concessions in debt relief.

The Fund is placed in a unique position to assess a country's capacity to undertake economic reform and its external viability. From this perspective, the Fund can encourage other creditors to accept more appropriate debt reduction. By the same token, the Fund is in a unique position to make the international community understand that, even when definitive action on debt is taken and sound macroeconomic policies are in place, a number of countries will require considerable net transfers from abroad. These resources have to be transferred under highly concessional terms.

Multilateral institutions, especially the World Bank, have important roles to play in providing technical assistance to low-income countries so that the effectiveness of bilateral aid can be increased. Perhaps the staff could comment on the progress that has been made in recent years on the institutional framework and policy design of bilateral aid for recipient countries.

It is regrettable that bilateral flows of official development assistance have declined during the past year--the first decline in four years. The staff's explanation for this is that increasing budgetary strains in most donor and creditor countries are becoming evident, but that does not seem to me to be convincing; there are always budgetary constraints. These budgetary constraints became real limitations when changes in policies or priorities took place.

It would be commendable if, as the staff suggests, aid as an instrument of export competition were to be transformed into available resources for the poorest countries. Again, multilateral institutions may have an important role to play in this regard.

It is encouraging to note that private market financing to developing countries continues to be strong despite some problems this year. Again, sound economic policies appear to be the main attraction for those capital flows. Sound economic policies will become more relevant in the near future, first, because of increasing competition among developing countries, and second, because developing countries are entering a period of rising debt amortization, as the staff points out.

Because the increasing integration of international markets will make interest rates and equity prices in developing countries more sensitive to developments in asset prices in industrial countries, as pointed out by the staff, the monetary, fiscal, and exchange rate policy stances will be increasingly important, not only in developing countries, but also in industrial countries. In the end, it will be in the best interests of the international community as a whole.

Mr. Shaalan made the following statement:

I wish to thank the staff for the well-focused review paper and the informative background documents prepared for today's discussion. They are certainly most welcome.

We had an opportunity to comment on some aspects of financing for developing countries and their debt situation that are covered in the papers before us in the context of yesterday's discussion of the World Economic Outlook. As I am in broad agreement with the concluding remarks set out in the final section of the main paper, I shall limit myself to a few comments on the role of multilateral institutions in the financing of developing countries. Specifically, I will briefly comment on the question of debt forgiveness by the multilateral institutions.

As noted by the staff, large net financing, particularly to low-income countries, has led to a significant rise in the share of debt to multilateral institutions. This, of course, would lead under existing arrangements to reducing the extent to which debt relief could contribute to easing the financing constraints faced by a number of countries, particularly low-income countries with a relatively high level of multilateral debt service. The staff rightly concludes, however, that moves toward debt forgiveness by multilateral institutions would be inappropriate, if not indeed counterproductive. The staff gives good reasons in support of this conclusion--not that any of us needed to be convinced of the validity of the conclusion, anyway. But I gather that the staff's discussion of the issue of debt forgiveness by multilateral institutions was prompted by outside calls for such initiatives. To the extent this is the case, might it not be useful to include a suitably edited version of the staff's treatment of this issue in the background paper on official financing, and have the latter published, also after appropriate editing?

I agree with Mr. Dorrington that, insofar as the Fund is concerned, it should always be looking for ways of utilizing all the resources of the Fund in the way that is most effective. As noted by Mr. Dorrington, the Fund has already done a great deal, including through the provision of ESAF resources. However, the balance of payments difficulties of at least some of the severely indebted low-income countries are clearly of a protracted nature. Given this, as well as the rising share in the financing of these countries that multilateral institutions, including the Fund, have been assuming, I wonder whether the imperative of avoiding debt relief on multilateral debts would not require, inter alia, a longer-term availability of an ESAF or an ESAF-like facility. As noted by Mr. Sirat, the real question seems to be rather the refinancing by multilateral institutions of their existing claims--that is, appropriate new multilateral money. In that respect, I strongly support Mr. Sirat.

Mrs. Wagenhoefer said that she did not necessarily agree with Mr. Sirat's point concerning access under a second ESAF arrangement.

Mrs. Wagenhoefer then made the following statement:

We join other speakers in thanking the staff for this most excellent documentation on financing for developing countries and their debt situation. The set of papers is comprehensive; considering that the Fund is a monetary, and not a developmental, institution, I might even call the staff papers overwhelming. As I firmly believe in Adam Smith's stipulation that a division of labor enhances productivity, I shall not comment on specific issues covered in the document, as this seems to be the prerogative of the Paris and London Clubs, but I shall constrain myself to a few general observations.

I fully support the staff's view that particular attention needs to be given to policies in debtor countries that will strengthen domestic savings and facilitate private sector flows. This is the area in which the Fund should concentrate its resources and help donor countries to reach that goal. Macroeconomic stabilization and the building of market-oriented institutions are indispensable for nurturing sustainable growth processes. As the many, welcome, examples of countries especially in Asia and Latin America have shown, such policies may generate private capital inflows of such a magnitude that they become a problem in themselves, albeit a benevolent one.

Non-debt-creating inflows are the key to medium-term balance of payments viability and domestic growth, especially if they are coupled with the transfer of managerial and technical know-how. Some countries unfortunately still resist such capital inflows by succumbing to ill-informed nationalistic cries against foreign direct investment. This is especially true in those countries in which foreigners are either completely barred, or at least constrained, from participating in the privatization of public enterprises.

The staff rightly notes that policy performance is rapidly becoming the single most important determinant of countries' access to financing from all sources, private and official. This is a most welcome development, as it links financial inflows to medium-term debt-service capabilities. The message for debtor countries is spelled out clearly by the staff: they will need to continue to strengthen their efforts to improve the effectiveness with which they use the aid they receive, and that they will have to have a clear commitment to policy reform to attract resources.

Concerning export credit financing, we share the staff's concerns about the more aggressive export promotion campaigns of many governments. While access to officially supported export credits remains crucial for many countries, exporters should in general compete on the basis of the quality and price of their products, rather than on the basis of associated subsidized financing. We fully support the recently intensified consultation process within the OECD, which is expected to reduce over time the scope for such subsidization. We want to underline the staff's warning that export credits are generally not well suited to substituting for general balance of payments support. The Board had to deal with some unpleasant cases recently where this rule was not observed.

We generally also share the staff's concerns about a proliferation of escrow accounts, which could encumber a large part of foreign exchange earnings of individual countries. Apart from causing a general major loss of future budgetary leeway, these accounts could also threaten the preferred creditor status of the Fund. I referred to the monetary character of the Fund earlier.

I fully support the staff's arguments against any consideration of debt forgiveness by the Fund. Debt forgiveness would pose serious dangers to the Fund's monetary character and the revolving nature of its resources, as other speakers have also pointed out. It would also undermine the willingness of members to continue to provide funding through quota increases or, as necessary, lending to the Fund. We should rather focus on ensuring the effectiveness of our policy advice and lending in promoting sustained economic growth in low-income countries.

Mr. Shaalan commented that debt forgiveness by the multilateral institutions had nothing to do with the monetary character of the Fund.

Ms. Lissakers said that she could infer from the dearth of Executive Directors around the table that the debt crisis was over, at least as far as the creditors were concerned. The staff had presented a set of interesting and useful papers that made it clear that the debt problem was not over for every member country or every government creditor--most importantly, for the multilateral creditors.

The experience of the preceding few years demonstrated that the machinery for resolving commercial bank debt and bilateral debt problems was working, with many variations and refinements, Ms. Lissakers continued. Some very large debt reduction agreements had recently been reached with Poland, Bulgaria, and Brazil.

She would oppose setting a firm cutoff point for the availability of Fund and World Bank financial support for commercial bank debt-reduction transactions, which some had suggested, Ms. Lissakers remarked. A number of smaller countries still had commercial debt negotiations ahead of them, and she would expect the Fund and the Bank to provide access to resources for debt reduction operations on a continuing basis until the outstanding problems were resolved. There would also be a substantial need for concessional resource flows and for sound macroeconomic policy advice, which was the key to long-term financial viability for the debtor countries--even those that had benefited from substantial debt reduction operations.

While the Paris Club was moving forward encouragingly on debt reduction, a large component of the world debt stock was not covered by the Paris Club--the substantial stock of Russian debt claims on many members, Ms. Lissakers pointed out. She hoped that a reasonable and equitable solution to that issue would be found soon. The size of the Russian debt claims called into question assumptions about the Fund's future lending operations, because while the methods of treatment of outstanding commercial debt and bilateral official claims were known, the methods of dealing with Russian debt claims was not. That made it difficult to have a clear idea of future debt-servicing obligations, flows, and capabilities for the countries concerned.

It could not be said that, in every case, stock-of-debt reduction was preferable to a reduction of debt servicing costs, Ms. Lissakers commented. At the same time, the finality of the former was a significant advantage. Also, as debt servicing capability could vary over time, depending, for example, on the evolution of export earnings, a debt-service reduction agreement that looked reasonable at one point might turn out not to be viable a few years later. There was an important psychological factor to stock-of-debt reduction that needed to be borne in mind: it provided commercial investors--who it was to be hoped would one day be the primary providers of financing--with a clear sense of a country's economic status. For those reasons, she favored stock-of-debt reduction where it was feasible and financeable. She was pleased to see that it was becoming increasingly feasible for the U.S. Government to do so, and that the budgetary legislation that would enable the United States to contribute more significantly to stock-of-debt operations through the Paris Club was being set in place.

She was aware of the differences in the way the World Bank and the Fund calculated debt servicing and debt-servicing capability, Ms. Lissakers went on. In her view, actual debt servicing, on a current basis, was a more accurate measure of the debt burden. The legal obligation to pay, even if a country had not paid for many years, had to be built into the calculations. The organizations were sometimes afraid to face reality in that respect; for example, Nicaragua had not serviced its commercial bank debt for several years, and that fact had been ignored in considering a Fund-supported program for the country. That would have to be resolved sooner or later precisely because the commercial bank debt was such an impediment to the normalization of Nicaragua's commercial relations with the world at large. The Bank and the Fund would have to get together on that issue; perhaps both calculations were needed to rationalize the structure of debt.

She was puzzled that only exports of goods and services, and not private transfers, were included in the calculation of debt-servicing capability, Mrs. Lissakers observed. In a number of countries, such as Uganda, Honduras, and Zambia, financial transfers from expatriates working abroad temporarily were an important component of the current account, which should be included. Perhaps the staff could comment on that issue.

The primary role of the multilateral institutions was to provide both financial support and sound macroeconomic policy advice, Ms. Lissakers stated. The Fund had adapted its lending programs to meet the needs of countries that were experiencing debt-servicing problems. The ESAF was an important mechanism for providing financing without making the debt servicing problem and the debt burden worse. The World Bank had also made beneficial adaptations to its lending programs.

She was not advocating multilateral debt forgiveness or debt reduction, Ms. Lissakers stressed. Even to discuss the subject, it would be necessary to make a clear distinction between the Fund and its monetary character, on the one hand, and the multilateral development banks, on the other hand. At the same time, she could not resist the opportunity to question some of the arguments that had been put forward against multilateral debt reduction, which appeared to be as spurious as many of the arguments that had been made against commercial bank debt reduction: in particular, that any debt forgiveness or debt restructuring by the multilateral institutions would jeopardize their credit standing. The fact was that the credit standing of the multilateral lending institutions was not a function of their loan portfolios, but of the credit standing of the major shareholders who stood behind those commitments. Also, the argument could be made that, as any debt-reduction operation improved the creditworthiness of the clients of the lending institutions, and the balance sheets of the multilateral lenders were strengthened as a result of the recognition of loan losses--as had been the case with the commercial banks--such debt-reduction operations would bolster the multilateral institution's credit standing, not weaken it. As long as multilateral debt reduction did not affect callable capital, she did not see the risks; it would not drive up the borrowing cost of the intermediaries. Nevertheless, she recognized that there were other reasons for not pursuing such a course.

The paper had made a number of useful points about export credits and the reliance on them for what was essentially broad balance of payments financing, Ms. Lissakers concluded. Mrs. Wagenhoefer had pointed to the fact that countries were competing on the basis of export credit terms rather than on the quality and price of the goods they were selling. That was a continuing issue in the OECD and other intra-governmental forums. The Eastern European countries in particular--but also others--often went too far in pursuing unwise long-term economic policies in the interest of near-term export gains. That might eventually pose a problem for the Fund. It raised a broader question about the relationship of the Fund and its economic surveillance process not only to export promotion institutions, but also--and more interestingly--to commercial lenders. The Fund's primary relationship was with individual member governments, not with commercial banks and commercial lenders, and it would be a violation of the confidential nature of the Fund's consultative relationship with individual member governments to engage in de facto credit reviews of individual countries and governments vis-à-vis commercial lenders and markets. At the same time, she wondered whether the Fund could do more, on a systemic basis, to inform the markets at large when it perceived worrisome trends in international financial flows, export credit lending, bond financing, or the pricing of international bonds, for example. Perhaps the Fund could raise a cautionary flag in such cases. The Fund might convene meetings on a regular basis--say, every quarter or every six months--with managers of mutual and pension funds and export credit directors to highlight what the Fund saw as weaknesses in data underlying credit analysis. Such individuals were effectively the intermediaries in an increasingly large flow of funds to and from member countries. The Fund as an institution had a responsibility, and something to gain, from thinking about that more than it had in the past.

The Deputy Managing Director asked whether Ms. Lissakers was proposing that the Fund ought to bring in potential or existing investors in developing countries for confidential briefings, or whether such briefings should be open to the public at large as well.

Ms. Lissakers replied that such briefings should be open to the public as well. The briefings would examine trends and flows in general, focusing perhaps on a few subjects, and not in the context of individual member countries. Confidential briefings would run the risk of a conflict of interest. More information would be made public than was the case at present, but in a focused and systematic way. The briefings might help to avoid the kinds of market mistakes that had occurred in the early 1980s--the consequences of which the Fund and other institutions had had to deal with.

The Chairman judged that Ms. Lissakers had made an important suggestion. The material currently presented in the Fund's annual review of international capital markets could be built upon. The review of capital markets was already an occasion to talk and exchange information with many of the institutions to which Ms. Lissakers had referred. More intensive communication between the Fund and those market agents might indeed be useful. The Fund could certainly go a step further, and play a more active role in raising warning flags. He was absolutely open to that suggestion; the Board and the staff could discuss how to start with the first steps in that direction. The world might reasonably expect such an initiative from the Fund, not only as a way of avoiding a new debt crisis, but also in light of the importance of developments in financial markets on which the Fund certainly had views.

Ms. Lissakers added that it was particularly important at the current juncture, when there were so many new players who were now the primary intermediaries with almost no experience in the markets concerned. Those players might not be as conscious of the risks involved as the commercial banks that had been through the purgatory of the 1980s.

Mr. Sirat agreed with the Chairman that Ms. Lissakers had made an important suggestion. Perhaps the Fund could do more in terms of discussing global trends with private investors. At the same time, he would be wary of having the Fund seen as a rating agency, and perhaps giving incorrect warning signals in respect of the situation of individual countries.

The Chairman agreed that such discussions by the Fund should remain at the systemic level, and not at that of individual countries.

Mr. Smee said that he agreed with Mr. Sirat's hesitation. The Fund should not be seen as turning into an agency issuing credit ratings on individual countries. That would be in the best interests of neither individual countries nor the Executive Board. Moreover, he always became worried when officials began to believe that they knew better than the private markets. The Fund should encourage the private sector to make its own decisions.

Ms. Lissakers explained that the Fund should absolutely not get involved in making judgments about the financing of individual member countries. That would indeed be a mistake. However, as the Fund had an overview of global and regional financial trends--such as the level of export financing and the role of such financing in the balance of payments of member countries--it would be useful for it to comment on those that it saw as potentially worrisome. The markets either might not be in a position to see those trends, or not inclined to take them into consideration. The Fund could play a useful role without violating the confidentiality of its relationship with member countries, or impeding its primary responsibility, which was consultation with individual member countries.

The Chairman recalled that when the debt crisis was at its climax in 1982, many voices had been raised claiming that no warning of the crisis had been given, and that the Fund and the World Bank had been remiss in that respect. The two institutions had been expressing growing concerns in that regard, however, in particular in the discussions of Working Party III of the OECD in 1979, 1980, and 1981, where the Fund had warned the various export credit agencies. Nevertheless, the Fund and the Bank had not shared their information with the markets. While doing so might not have prevented the debt crisis, it might have prevented the kind of follow-the-leader behavior that had characterized the international banking community at that time, which had indeed intensified as the moment of the meltdown approached, with the Mexican situation of August 1982.

To share with the markets from time to time the Fund's perceptions of current trends might be useful in persuading economic agents to modify somewhat their behavior and to act more prudently, the Chairman observed. Perhaps the sharing of information could be effected through the Fund's publications, or in the context of the various meetings in which it participated, or which it organized. The Fund was uniquely situated to synthesize and analyze the information that it received in the context of its mandate, and to make its conclusions known to the public and to market participants might be a useful adjunct to its role.

Mr. Smee said that he took the Chairman's points, but at the same time, the Fund must have been advising Mexico in 1982 that it was borrowing too much, and that it had to initiate greater fiscal and monetary restraint. If the Fund had said in 1979 or 1980 that Mexico depended too much on external financing, then that financing might have ceased completely almost immediately; surely, that would have been entirely counterproductive. Alternatively, the financing might have been transformed into a type that was even more worrisome, with usurious rates of interest attached to it. Even on a systemic basis, the Fund needed to proceed very gingerly in that regard.

Ms. Lissakers commented that Mr. Smee's reasoning demonstrated perfectly the logic that had led to the debt crisis of 1982.

The Chairman said that he recalled the accumulation of very short-term debts by Mexico in the 18 months before August 1982, which had not made a solution to the crisis any easier.

Ms. Srejber commented that the Fund could discuss the sharing of information on market developments with market participants, but the Fund already published many of its views. Perhaps a discussion and analysis in a more interactive forum would be more useful, and indeed, it might be useful for the Fund to hear the views of market participants. Nevertheless, she had the same concerns as Mr. Smee about the potential for the Fund to make a bad situation even worse. Her experience with the banking crises in Sweden and Finland suggested that market participants, notwithstanding warnings that were given, often believed that they were more clever than the rest, and that by moving quickly they would avoid the problems of others. She was not convinced that people would necessarily listen to wise advice.

Mr. Shaalan observed that Ms. Lissakers had said that only global financial trends would be discussed. If that were so, then he wondered whether the Fund intended to go beyond what was included in the published version of the World Economic Outlook, and if so, what it was likely to be.

Mr. Kafka said that he was grateful Mr. Smee and Ms. Srejber for their comments, with which he agreed. He had been listening with increasing concern to the debate about the Fund putting up warning flags. Mr. Smee, who had played an important role in the debt crisis, especially with respect to Brazil, was absolutely right that untold and unexpected damage could be done by providing advice and information in certain situations. Moreover, one should not believe that anything could be kept confidential; if the Fund issued a warning not to lend to a certain country, that warning would be known by the markets.

Mr. Dorrington said that he agreed with Mr. Smee's observation. Regarding Ms. Lissakers's point about the measurement of debt, he believed that the World Bank methodology was an important approach to be used in a particular set of circumstances. That was not to say that it was the only indicator, or necessarily the best indicator for looking at some other things.

The Chairman said that the Board would have a discussion on the issue of the dialogue with the markets some time in the fall of 1994. That discussion might clarify the Fund's expectations for such a dialogue, and the kinds of precautions the Fund should take.

Mr. Giulimondi made the following statement:

> I join other speakers in commending the papers before us today, which provide both an extensive and an in-depth examination of this subject. I also found very interesting and stimulating the statements by previous speakers and the statements circulated by Directors. I fully agree with the staff regarding commercial bank debt restructuring, as it is treated in the report.
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> I can accept the staff's views regarding official debt restructuring, which encourage clear-cut stock-of-debt solutions for the debt problems of the lowest income and most indebted countries. This is in line with the welcome outcome of the Naples G-7 summit. Still, it should be stressed that the stock approach is not the only--or necessarily the best--means to address the debt overhang of all low-income countries. In this respect, I endorse the view expressed by Mr. Sirat that rescheduling of flows can remarkably improve debt-service profiles, allowing, in the meantime, renewed access to bilateral official flows by maintaining cut-off dates that protect credits subsequent to those dates. In any event, in order to avoid belittling the new strategy and creating moral hazard problems on the contracting of new debt, stock reductions should meet the conditions listed on page 16 of the paper--namely, good track records in debt servicing, the maintenance of close links between payments and new financial assistance, and medium-term adjustment frameworks agreed with the Fund. In addition, I agree with Ms. Lissakers and others

that the more radical stock approach should be considered when it may reasonably allow for an exit from the rescheduling process.

Concerning private financing flows, I would like to associate myself with the point made by Mr. Sirat on public bond seniority and the nature of the private sector bonds. It is evident that material difficulties for the repayment of public bonds may be generated by the increasing share of bonds in total liabilities. Nevertheless, any weakening in the reliability of this financial instrument would affect very seriously the degree of freedom of developing countries in resorting to differentiated instruments to address budget financing needs.

Regarding official bilateral financing, and in particular, the securitization of export credits through the establishment of escrow accounts, I agree very much with the assessment of the problem given by Mr. Dorrington. The waivers of negative pledge clauses granted by the World Bank and regional development banks were designed precisely to attract foreign financing that would not be available otherwise to assist the transition to the market of transforming economies. Such waivers are granted at the very point at which these countries come to rely on the incremental nature of the investments which, in the medium term, should provide additional hard currency, and contribute to easing the debt-servicing problems. While the possible proliferation of escrow accounts might justifiably be a cause of concern, such accounts should not raise concerns about the Fund's preferred creditor status.

With respect to the behavior of export credit agencies, I fully share the staff's view that competition among exporters should be brought back to its proper basis, namely, the comparison of quality and prices, rather than of the associated financing. In this respect, the Helsinki package will be extremely important to reducing the inappropriate contamination of development aid strategy with export support mechanisms.

I fully endorse the often repeated statement that the idea of debt write-offs by multilateral institutions is strongly objectionable. However, it is not clear what the Fund should do to address the problem of debt overhang with respect to multilateral institutions. I agree that financial involvement and the provision of new money by the Fund should not violate the monetary character of the Fund. This requires the maintenance of strong conditionality standards in extending traditional facilities and in any revision of the set-aside mechanisms for debt reduction operations.

Mr. Trivedi made the following statement:

This discussion provides an opportunity to exchange views on matters relating to the flow of funds to the developing countries from both private and official sources.

It is good news that the Paris Club is soaring ahead with its job of rescheduling and restructuring the official bilateral debt of low income countries. A track record of having handled 45 out of 61 identified low middle-income countries is indeed very impressive. Also, the French initiatives on debt write-offs or forgiveness are laudable.

However, the financial flows from official bilateral sources, which are a critical source of finance for the developing countries with low and middle incomes, have nosedived in the past few years. In 1993, total net bilateral disbursements to all developing countries declined to $43.6 billion, in contrast to $49.5 billion in 1992. This was a fall of about 12 percent; and to the low-income countries, the fall in net disbursements was equal to 11 percent. It is understood from the staff report that one of the major reasons for this could have been the budgetary constraints of the donor countries, combined with less need, as reflected by fewer and smaller requests from some of the largest recipients of flows of official development assistance. In last year's intervention, this chair asked if we could possibly analyze the reasons for the fall in these disbursements beyond the reasons that have already been quoted, and check if it is because of the presence of conditionalities relating to issues such as the environment. I assume that the absence of any comment from the staff on this point is tantamount to saying that such conditionalities have nothing to do with these falling disbursements.

There was also a fall of 2.3 percent in the official bilateral flow of credit to those countries in which rescheduling is in operation. Although disbursements under this head are linked to the implementation of appropriate economic policies, in which the Fund also has a stake in terms of its involvement, it will become difficult for a country to avail of official development assistance if restructuring was to falter at any stage, leading to a "Catch-22"-type of situation. However, this is only a theoretical situation, and in any situation, a more coordinated approach and a well-knit arrangement are preferable.

I also find it surprising that the World Bank adopts a different criteria for the identification of debt overhang than the Fund, but both try to resolve the debt problem. It seems like a situation in which a patient is treated for the same ailment by two different schools of medicine. The Fund mode of treatment, on the one hand, is like naturopathy, where before a stock-of-debt operation is done, the country is expected to restructure and adjust according to the Fund menu for the first few years. By following this approach it is expected that the country will rejuvenate itself and be in a position to service the debt obligations after they have been reduced by a stock-of-debt operation, and thus create an environment for resource transfers and private capital flows. The Bank, on the other hand, treats the country by using a sophisticated and complex methodology of assessing the severity of a country's debt, by considering the debt/export ratio on a present value basis as an indicator; whenever the urgency is established, an operation is conducted. Such an assessment has specialized data requirements, such as a highly subjective discount rate--and the sensitivity of that to the assumptions behind it--as well as the estimation of future exchange rates, export earnings, and elasticities that are likely to prevail, notwithstanding the famous argument of "other things being equal," on which economists are so fond of relying.

It is not clear how the various conflicts that may arise owing to a differing emphasis in the selection of countries for the purposes of debt and debt-service reduction are resolved. Who deserves the maximum help? The methodology used by the two top multilateral funding institutions has the potential of throwing up two different answers. I am not sure whether this is by design or by default. If the latter, then are we trying to resolve the contradiction, or is a dialogue with the Bank on this issue planned?

Chart 2 on page 22 of the background paper on official financing for the developing countries shows that guaranteed credit from private creditors to the low-income countries has historically been small. This is not surprising if we try to understand the perceived risk of entrepreneurs in these countries. What is surprising is that bilateral and multilateral flows have also been lower in these countries as a proportion of the total flow to all the developing countries. There is scope for further consideration of this issue in the Fund and in other multilateral institutions.

Of the different forms of capital flows, such as bonds, commercial bank credit, and equities, the role of equity-based investment has been the most critical from the point of view of the flow of private capital. The bond market also is an avenue that many countries have explored successfully, especially China and India--through the Euromarket. However, the participants are few.

Streamlining regulations and strengthening the institutional framework are the most important factors in attracting capital to an emerging stock market. Countries all over the world have attempted to establish a regulatory environment that is conducive to transparency, encourages smooth clearing and settlement procedures, curbs insider trading, and generally creates a healthy trading environment. However, much more remains to be done, as sufficient confidence has yet not been generated.

Mr. Sirat commented that he saw no major difficulties in having the Fund staff and the Bank staff using different methodologies to assess the debt situation of countries. In fact, as Mr. Dorrington had said, it was probable that, to get a clear picture of the precise situation of a given country, both methodologies--both the debt-stock ratio and the debt-service ratio--should be used. It might well be that the Paris Club, in its final decision on debt stock restructuring, would use a third methodology--that of neither the Fund nor the Bank. It might put more importance on the proportion of bilateral debt in total debt.

The Chairman said that the Fund was working with the World Bank on the issue of the methodology for assessing the debt levels of member countries. The staffs of both institutions might issue a common paper explaining the differences in the methodologies and making suggestions for how to find common ground.

Mr. Ortiz Vely made the following statement:

We join other speakers in commending the staff for the excellent set of papers prepared for today's discussion. We are pleased to note the explicit reference to concessionality granted by nontraditional official creditors in debt-reduction agreements for low-income countries. The continued progress toward debt restructuring with commercial banks and official creditors, and the increasing access to international capital markets by several middle-income countries, is encouraging.

The past debt and debt-service reduction arrangements have restored solvency, contributed to international financial stability, and helped to create new trade and investment opportunities, thus benefiting both debtors and creditors alike. The packages that have been agreed with 20 heavily indebted middle-income countries represent the restructuring of 75 percent of debt owed at end-1989 by this group. We are confident that the remaining indebted middle-income countries will be able to regularize satisfactorily their relations with their creditors in the near future. This being said, debt difficulties and arrears continue to overburden the prospects for solvency and growth in many low-income countries, particularly in sub-Saharan Africa. In this regard, although creditors have continued to adapt their rescheduling practices to country circumstances, it is evident that more needs to be done.

While no stock-of-debt operation has yet been implemented by the Paris Club creditors, the recognition by the G-7 leaders at the Naples summit of the need to improve the debt treatment of the poorest and most indebted countries, to support a reduction in their stock of debt, and to increase concessionality for those countries facing special difficulties, is most welcome.

The focus of future debt-restructuring programs ought to continue to be based on assessment of the country's prospects for medium-term external viability. The terms and conditions of the restructuring exercise should then be tailored to the debt servicing capacity and needs of the country concerned. Countries that follow sound macroeconomic policies and undertake the necessary structural reforms should be provided with a well-defined opportunity to adjust their way out of the external debt problem. To this end, access to industrial countries' markets is essential.

We see merit in the use of a debt/export ratio, on a present value basis, as an indicator of the severity of debt overhangs, so as to tailor the debt problem solutions of severely indebted low-income countries to their individual circumstances. Continued Fund support will be of crucial importance to determine the appropriate tailoring and the eligibility of a country to benefit from stock-of-debt operations.

Regarding financing flows to developing countries, it is interesting to observe that, for those countries that have regained access to capital markets, sources of financing--and the recipients of financing--have changed, therefore modifying the nature and composition of a country's external debt. Bank lending has continued to diminish considerably, has become almost exclusively short term, and is being increasingly centered around instruments that protect against country transfer risk. At the same time, for middle-income countries and some lower middle-income countries, international capital markets continue to be the major source of funding. On the recipient side, the massive privatization of state enterprises and the overall emphasis on the private sector as the engine of growth ensure a more productive use of resources and a concomitant reduction of risk. Private indebtedness is rapidly becoming the largest component of countries' external debt. This being said, the new and evolving pattern of financing flows to developing countries deserves continued monitoring by the staff.

In addition, we particularly welcome the analysis of special security arrangements and of the World Bank's negative pledge clause. While it is noted that lending secured by escrow accounts has not yet led to major additional inflows to economies in transition, the sizable agreements with Russia highlight the potential complications of a proliferation of these practices for future macroeconomic management, with possible spillover effects impinging on the Fund's preferred creditor status. Developments in this regard should be assessed regularly in the staff's future analyses.

We would like to emphasize the importance of well-functioning, market-based economies and a strong multilateral trading system for avoiding future debt crises. A national and international environment that fosters an efficient allocation of resources and promotes trade provides the best option for developing countries to achieve sustained growth and generate the resources needed to meet their foreign obligations. Equally important are the reforms needed to establish reliability in domestic capital markets so as to attract foreign capital and minimize its volatility.

Mr. Cippa made the following statement:

I would also like to thank the staff for its comprehensive review of the progress under the debt strategy. Ingenuity, flexibility, and generosity have been essential ingredients in the debt relief strategy, and contributed heavily to the numerous cases of success; they will be needed also in the future to overcome the problems mentioned in the papers, such as, for example, the complications arising from "pre-Brady" debt speculation, problems of secondary market pricing for the debt of low-income countries, and the scarcity of available concessional resources. However, the pursuit of a credible stabilization effort and structural adjustment remains a basic condition for a long-lasting solution of the debt problem and an eventual resumption of voluntary financing. As I generally share the staff's overall assessment of recent developments and prospects, I will not elaborate on all the issues suggested for discussion and concentrate my remarks on the question of multilateral debt--an issue that is crucial for this institution--and on private capital inflows.

Allow me to share the discontent of other Directors with the different way the Fund and the Bank measure very important magnitudes related to the debt issue. I am referring in particular to the definition of the debt-servicing capacity of a country, or the measure of net financial flows to developing countries. In the latter respect, the Fund does not take into account charges and interest payments to multilateral institutions, thereby reducing in its statistics the size of the net transfer that occurred in the past years from developing countries to multilateral institutions. I agree with Mr. Sirat that neither methodology is wrong, and that, inasmuch as they remain fully transparent, they should not bother any conscientious economist. Nevertheless, as they might generate confusion and misunderstanding--one might get the impression that the Fund is taking a more optimistic--and perhaps exaggeratedly so--attitude--a consolidation of the methodologies used by the two institutions would be welcome.

Multilateral debt as a share of the total debt of low-income countries has been increasing. Various sides have voiced their concern about this development, and consider multilateral debt servicing a burden on low-income countries' capacity to pay. Suggestions have been put forward for debt forgiveness by multilateral institutions. I agree with the staff that this issue should be addressed, and that the role of the Fund should be put in the correct perspective. However, I oppose any notion of forgiveness. Debt forgiveness would be counterproductive and would create all sorts of problems for the Fund. Debt forgiveness would threaten the revolving nature of the Fund's resources; it would increase the cost of Fund credit, hurt the Fund's ability to lend, and violate the principle of equal treatment; moreover, it could undermine the willingness of members to continue providing funding through quota increases or other terms of lending.

The Fund plays an important role in advising highly indebted low-income countries and in bringing them back onto a sustainable growth path. The financial support the countries receive from the Fund makes up a small share of their overall financing needs. This is in line with the Fund's catalytic role, which must be preserved. Most of the increase in multilateral lending has been to low-income rescheduling countries. These are countries that have established a positive record of policy performance in implementing the rescheduling agreement and that have achieved progress under a Fund arrangement, but that are still far from reaching external viability. However, there are cases where it appears appropriate to help countries to clear arrears to international financial institutions in order to allow them to renew their linkages with the international financial community. The Swiss Debt Reduction Facility can provide such a fund in the context of appropriate arrangements and international burden sharing.

As the staff points out, the core of the problem for most countries is not multilateral debt servicing, but the unsustainable debt servicing on restructurable debt. I agree that more debt reduction by private creditors and official bilateral creditors would bring down debt payments to manageable levels for these countries, and must be encouraged. It is important, however, that a country's indebtedness be reduced on a net basis; replacing bilateral with multilateral credit will not help, as future flexibility in debt management will be even more impaired as these latter credits cannot be rescheduled.

Forgiveness should not be an option in multilateral debt. However, we should think of other possible solutions. Increased concessionality and the development of programs on the model of the Fund's rights accumulation program, for example, should be encouraged in other international financial institutions.

The resurgence of private financing to developing countries is the most visible fruit of past reform efforts. Successful adjustment and stabilization efforts explain only part of these inflows, however. Sluggish activity in industrial countries and the associated decline in their interest rates have also contributed to this phenomenon, as the important market corrections following the rises in U.S. interest rates have shown. Developing countries have to face the problem that every economy linked to the international financial markets has to deal with: how to reconcile the advantages of being able to tap long-term foreign capital with the potentially disruptive effects of the volatility of financial markets.

While adopting adequate policies may be effective when capital tends to flow out, following this strategy in case of capital inflows may be useless, or may even accentuate the movement. If capital inflows are attracted by the high domestic short-term interest rates required by the country's economic situation, for example, adopting an even firmer monetary stance will not help. In such a situation, we think that the staff should take a more positive look at the measures that could be taken to discourage temporarily short-term capital movements.

If capital inflows are triggered by enhanced investor confidence in the country's economic prospects, the problem amounts to reducing the risk and effects of disruptive changes in financial market sentiment. Efforts to increase information on the policies implemented, on the firms the shares of which are being traded on the market, for example, coupled with measures enhancing the soundness of the domestic financial sector, may contribute to strengthening this confidence. Governments may also reduce the impact of shifts in foreign interest rates by monitoring all forms of external borrowing. Borrowing short term, for example, generally proves riskier, and the terms tend to be more volatile than those on long-term debt. The growth of derivatives issued by developing countries on international markets should also be monitored closely.

In addition to this problem of increased volatility, one should also be cautious with respect to the sustainability of such flows and on their possible role for financing development. Portfolio flows, for example, have been attributed to the low or even negative yield correlations between emerging markets and industrial ones. As Western investors will increase their stake in developing countries' securities markets, this correlation should be expected to rise. Foreign direct investment has been linked to the privatization programs developing countries are implementing. These programs will end sooner or later. Finally, as the staff points out, private capital inflows have been concentrated on only a few countries, primarily in Asia and Latin America. The World Economic Outlook suggested that, at least for Latin American countries, investment had not increased significantly, indicating that foreign capital has simply substituted for domestic savings.

Mr. Smee made the following statement:

I would like to take this opportunity to speak on the issue of external debt owed by developing countries to multilateral institutions--international financial institutions.

Let us all acknowledge that the Fund already reschedules its claims on developing countries and carries out debt-service reductions as well. Of course, we never admit this publicly, nor do we call what we are doing by these names. However, we reschedule our claims through the rights accumulation program--that is, we push out existing maturities into the future. We carry out debt-service reductions through ESAF loans--that is, new debt is at concessional interest rates, which lowers the average interest rate prevailing on the total amount of debt. Net present value calculations could be done to determine the impact, as in commercial and official bilateral creditor operations.

Thus, in talking about forgiving international financial institution debt, we are not establishing any precedent, even though all my colleagues have eschewed it as unworkable, impractical, and just plain wrong. In this respect, I agree with Ms. Lissakers that the considerations outlined in the staff paper are, in most cases, overdrawn and self-serving.

Turning first to rescheduling, the present rights accumulation programs only apply to the original 11 cases of protracted arrears for a specified period of time. I believe that, for developing countries with liquidity rather than solvency problems, we should change the rights accumulation process so that it can apply to any country with certain, carefully defined external debt problems, before a protracted arrears situation has developed. That is, reschedule when the problem first becomes evident, not after the country has sunk so low that the economic and political costs of pulling out of the hole are so large that they can hardly be contemplated.

For various reasons, including debt and debt-service reduction by commercial and official bilateral creditors, claims of international financial institutions on low-income rescheduling countries are approaching 50 percent of those countries' total external debt, which is also the share of official bilateral creditors. With most of these countries, we can no longer speak of the Fund's catalytic role. We are now part of the problem, not the solution. Just as the debt overhang is used to press for commercial and official bilateral creditor debt and debt-service reduction, it now applies to the Fund and to other international financial institutions as well.

What can we do? We could extend the debt-service reduction characteristics of the ESAF to include total debt--that is, with a suitable track record of economic reform and commitment to it, the Fund would subsidize the interest rate on all Fund claims on the country, not just on new loans. The other international financial institutions could do an equivalent amount.

For countries that have no non-ESAF debt to the Fund, and where even concessional rates are not enough, the Fund could begin to actually write down the value of the claims. The other international financial institutions could do an equivalent amount.

How can the Fund pay for it? We could enlarge ESAF subsidy resources, although I see this as very problematic. We could sell gold, and use the profits or the incomes from the profits. Or, in the case of concessionalization of our total claims on a country, we could pay for it with fair burden sharing of our income target. We could pay for debt reduction with fair burden sharing of our precautionary balance accumulation. In either of these last two examples, we are paying for it with a tax expenditure, which does not require parliamentary approval, rather than by a budgetary appropriation, which does require parliamentary approval, as do ESAF subsidies now.

We must be more imaginative. We cannot just leave the problem of developing countries that owe a large share of their external debt to international financial institutions to languish. To do so is to be irresponsible.

Mr. Sirat commented that he had some sympathy for Mr. Smee's analysis of what the Fund was effectively doing in respect of the debts of highly indebted countries to the Fund. However, he had doubts about what further steps the Fund could take to resolve the problem. For the Fund, it was indeed a question of burden sharing. Effectively, bilateral creditors currently bore much of the burden, as, through the rescheduling of debt owed to them, amounts were freed that enabled the payment of Fund debt by the debtor countries. That, in turn, had an impact on the level of the rates of charge and of remuneration. So, for the Fund, the question could be seen as merely a choice of different ways to distribute costs. It was also a question of whether such mechanisms could be continued, or whether the Fund should reschedule its claims outright, with the resultant need to share the burden of the effects of rescheduling on the Fund's income. However, the situation was different for other multilateral institutions that financed themselves on the markets, because the question of a potential rescheduling was much more complex, and not merely an issue of burden-sharing.

The Chairman agreed that the situations of the Fund, the World Bank, and the multilateral development banks were quite different, as Mr. Sirat had suggested.

Mrs. Wagenhoefer stated that she could not agree with much of what Mr. Smee had said about the role of the Fund in rescheduling.

Mr. Kafka made the following statement:

> We are grateful to the staff for an impressive set of papers. Again, we feel that an executive summary would be helpful not only, but especially, when there is a large volume of papers for discussion.
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> We agree with the staff that the framework for resolving bank debt problems has become effective. It is good to remind ourselves that this has been a very gradual process, indeed an excessively gradual one. It is only since the international community's approach has come to comprise debt and debt-service reduction that real progress has been made.
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> We strongly agree with the staff that it is necessary that the remaining middle-income countries that have not yet resolved their commercial bank debt problems not only pursue stronger policies, but that their creditors show additional flexibility. The staff also deserves our thanks for calling our attention to the danger of "pre-Brady" debt speculation driving up secondary market prices, and to the problems posed by substantial numbers of nonbank investors who hold the debt of these middle-income countries and can create serious problems for resolving their debt problems.
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> Regarding the bank debt of low-income countries, we agree with the staff that steeper discounts for buy-backs and debt exchanges that limit collateral and terms based more explicitly on an assessment of the debt-service capacity of these countries will be necessary.
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> Regarding the official debt of low-income countries, debt-stock operations, instead of debt-service restructuring, should be given the support of the Fund. It is also very helpful for the staff to state that, in view of the large net transfers of resources that low-income rescheduling countries will continue to

require, exit restructuring should be designed carefully, so as not to jeopardize future official assistance to those countries. We agree with the need for appropriate concessional lending to these countries not only by bilateral creditors, but also by multilateral institutions.

The fluctuations to be expected in the inflows and outflows of private capital into and from developing countries may, as the staff claims, authorize a degree of optimism regarding their sustainability, but they also may raise the question of the possible need for a very short-term facility to help meet balance of payments problems that these fluctuations may create.

More generally, we agree with the staff that debtor countries should continue to promote their growing integration into the world economy, but we also believe that these countries may, on occasion, need to use restrictions to deal with inconvenient capital flows, naturally taking appropriate precautions not to minimize the dangers of prejudicing their access to the international capital markets. We have some concern about the possible misinterpretation of the recommendation by the staff that greater government monitoring of all external borrowing remains essential. We believe that prudential general rules should in most cases be adequate, without requiring specific authorization by governments of external borrowings to assure an adequate stance with respect to additions to external debt. Perhaps this is all.

We also strongly subscribe to the staff's suggestion that the use of official aid as an instrument of export promotion should be reduced so as to conserve scarce aid reserves for the poorest countries. We also believe that care is to be taken by countries obtaining officially-supported export credits to recognize the limitations of such financing for countries that require prolonged net financial inflows.

The privileged creditor status of the multilateral institutions is the counterpart of continued support for their debtors even during periods of crisis. The significant increase in the share of debt owed to multilateral institutions should not be an excuse for failure to continue to extend financial support to their debtors. The combination of good policies and appropriate financial conditions can help the multilateral institutions very well to continue to play their role without prejudice to their soundness.

Mr. Lee made the following statement:

The lucid presentation by the staff provides both encouraging and worrisome aspects of the issue of financing the debt situation of developing countries. While there has been marked progress with regard to the debt situation of middle-income countries, the situation facing low-income countries appears to be less satisfactory. I generally agree with the staff's comments.

We are most pleased with the progress made on commercial bank debt restructuring in the case of middle-income countries. However, given the severity of the situation of some low-income countries, the suggestions by the staff to reduce up-front costs, such as buy-backs at steep discounts and par bonds at lower interest rates, deserve serious consideration.

The encouraging outcome for middle-income countries with reschedulings under the Paris Club reaffirms the constructive approach taken by creditors on granting enhanced concessions and phasing debt settlement, as well as the success of these countries in adhering to strong programs. However, low-income countries appear to require additional effort given the severity of their debt situation. The debt-stock operations approach continues to be a viable option, and in that respect, I agree with Mr. Dorrington's comments on this.

With respect to private financing in developing countries, I am in agreement with the staff's analysis. It is necessary that developing countries continue to implement sound macroeconomic and structural policies, and enhance financial market developments in their respective countries. These will also assist in reducing the risks from reversal of private capital flows.

The fall in official development assistance has serious implications for developing countries. The structural fiscal deficits and increasing indebtedness in a number of major industrial countries will continue to constrain an early recovery of assistance to previous levels. In this regard, multilateral institutions will continue to play a critical role in providing advice and financial assistance.

Like other speakers, I found the staff's arguments very convincing against debt relief from multilateral institutions, particularly the Fund. I support the staff's conclusion.

Mr. Aderibigbe made the following statement:

We commend the staff's effort in preparing this comprehensive review of the debt situation in developing countries. No doubt, appreciable progress has been made in addressing the debt problems of developing countries, resulting in some easing of the debt burden and increased inflows of resources on improved market terms in some of the countries. In particular, efforts by a number of middle-income developing countries to normalize relations with creditors and regain access to the international financial markets enjoyed further impetus during the past year. A number of ongoing negotiations on commercial bank debt restructuring operations were successfully concluded, while a few more countries graduated from the Paris Club credit rescheduling process. To a considerable extent, this development has been facilitated by the continued commitment of debtor countries to the reform effort, and the more flexible approach adopted by creditor countries and multilateral institutions, including the Fund and Bank, in dealing with the debt issue.

However, despite these positive changes, the debt crisis is far from being over for many low-income developing countries, particularly those in Africa. Notwithstanding the various debt relief initiatives that have been put in place, the African debt problem persists, which, together with the frequent external shocks, including the persistent terms of trade losses, seem to undermine the countries' adjustment efforts. This critical situation has been well illustrated in the current world economic outlook paper by noting that the average debt ratios in Africa have remained steady at the high levels of the 1980s. Furthermore, and in the particular case of sub-Saharan Africa, the world economic outlook paper observes that the region's debt/export ratio in 1993 was three times the developing country average, and that only modest improvements are projected for 1994-95. Also, in contrast to other regions, the debt-service ratio for the sub-Saharan African countries is projected to continue to rise through 1995, despite the current debt relief effort.

It has become obvious that for most of these countries, a definitive resolution of their debt problems would require more than mere relief of debt obligations; it would involve a more comprehensive approach aimed at reducing the stock of debt. It is pertinent to note in this regard that after about one decade of adjustment efforts and successive debt reschedulings, only 19--or less than one third--of the 61 countries that have required Paris Club debt relief have actually graduated from the rescheduling process. In fact, out of these 19, only 3 are low-income countries. It is noteworthy that the current Paris Club menu of concessions offers a good opportunity for more decisive action to deal with the debt problem. We therefore urge all official bilateral creditors to adopt a more pragmatic approach in implementing the stock-of-debt operations for low-income countries envisaged under the menu of enhanced concessions that had already been agreed by the Paris Club creditors. The activation of the goodwill clause featured in most of the existing rescheduling agreements appears to be encumbered at present by the requirement of a three-year waiting period between flow rescheduling and the stock-of-debt operations. There is little surprise, therefore, that until now, no such operation has taken place. A shift from the current Paris Club criteria for qualifying for the stock-of-debt operation to a more flexible approach that focuses on reducing the debt-service obligation to levels consistent with the countries' capacity to pay over the medium term, in line with the proposal in the World Bank study, would be more appropriate. Indeed, the staff calculation shows that a 50 percent stock reduction would lower the debt-service ratio to a sustainable level for many low-income rescheduling countries. We consider that the number of 50 percent is only an indicative number, because some debtor countries would require a more substantial reduction.

We welcome the recent action by the Paris Club creditors to extend the concessional debt rescheduling terms for low-income countries to two lower middle-income countries, and we hope that this would open the door to other debtor countries in that category.

On commercial bank debt relief, we note the concessional assistance provided by the World Bank under its debt reduction facility for IDA-eligible countries. The augmentation of the existing resources by other official bilateral donors, and increased flexibility on the part of the commercial banks in the negotiation process, would enhance the impact of this facility on commercial bank debt restructuring for low-income developing countries. It is a matter of concern that only six countries have benefited so far from this facility.

Regarding new financing flows, we note the welcome developments related to increased private resource flows to developing countries in 1992 and 1993. The perceptible shift from direct bank lending to bonds and equity flows has been accompanied by a surge in foreign direct investment inflows. These sources have been viewed as potentially stable and more suitable for development financing, and should thus be encouraged. The importance of ensuring that official actions guide the orderly behavior of the market so as to avoid systemic risks cannot be overemphasized.

It is regrettable, however, that the bulk of these flows has gone to only a few Asian and Latin American countries. Indeed, African countries have attracted very little private capital, and they continue to rely more heavily on official bilateral and multilateral financing sources than other developing countries. It should be recognized that additional financial resources are indispensable complements to debt relief in order to ensure that adjustment is accompanied by sustained growth and external viability. While we expect that progress toward a resolution of the debt problem would improve the prospects of access to international financial markets, in the meantime, the majority of the low-income developing countries will continue to rely largely on financing from bilateral and multilateral sources. It is essential that these transfers be increased and provided on highly concessional terms. In this regard, any request for debt forgiveness from the multilateral institutions, including the Fund and Bank, may not be consistent with the reality of our needs.

The current decline in the net disbursement and commitment of bilateral official development assistance resources is a matter of concern to us. We therefore appeal to donor nations to address this concern by increasing the size and improving the quality of their financial assistance to low-income developing countries.

Mr. Mozhin made the following statement:

I join other speakers in complimenting the staff for the excellent set of papers. I am in broad agreement with the main conclusions of these papers.

I welcome the fact that most of the middle-income rescheduling countries have now graduated from the Paris Club rescheduling process, or can be expected to do so at the end of their current consolidation periods. At the same time, although the debt situation of these countries is no longer a threat to the international financial system, it will remain difficult in the period ahead, and will continue to deserve the special attention of the Fund. As their remarkable progress has been mainly a result of the successful implementation of sound macroeconomic policies, any deviation from such policies could lead to the rapid deterioration of their debt situation.

For most of the low-income rescheduling countries, graduation from the Paris Club rescheduling process remains a distant prospect. In fact, for most of these countries, the current levels of originally scheduled debt service appear unsustainable. As indicated in the staff paper, for these countries, as a group, scheduled debt service in 1993 amounted to about 60 percent of their exports of goods and services, as compared to about 20 percent of actual debt-service payments. Therefore, I agree with the staff that, for many of these countries, there is practically no alternative to debt stock operations that would provide them with a sustainable medium-term debt-service profile.

I welcome the fact that successful implementation of sound macroeconomic policies has allowed the group of middle-income developing countries, as well as several economies in transition, to create favorable investment opportunities and to regain access to private external financing. However, for the great majority of developing countries and economies in transition, official external financing will continue to play a major role. Because in recent years the share of multilateral financial institutions in providing official financing to these countries has been growing rapidly, there is clearly a need for a stronger effort on the part of bilateral creditors. In that respect, I believe that official export credit agencies have an important role to play, including through securitized lending arrangements.

Although I agree with the staff that there is a danger of proliferation of escrow accounts, in my opinion this danger is still only hypothetical. As indicated in the staff paper, the authorities of the borrowing countries so far have been reasonably cautious in their attitudes to escrow accounts.

Regarding the coverage of the staff's analysis, I agree with Ms. Lissakers that the coverage of developing countries' debts to Russia is an issue. Also, it is regrettable that there is no reference in the staff papers to the debt situation of the countries of the former Soviet Union other than Russia. Meanwhile, in recent years, the external indebtedness of several countries in the region of the former Soviet Union has been growing very rapidly. For example, the external debt of Georgia has risen from zero to more than 100 percent of its GDP only three years after independence. Also, I would like to draw the attention of the staff to official financing arrangements in the region of the former Soviet Union, without which the global picture is simply incomplete. The European II Department can provide the necessary data on that subject.

Mr. Ismael made the following statement:

I am happy to note the continuing progress in resolving the external debt situation of highly indebted developing countries. Nevertheless, there are still some middle-income and low-income countries facing a difficult external debt situation that requires treatment other than the current strategy--in addition to some debt cancellation--in order to help those countries reduce their debt payments to manageable levels, and to help them to grow out of their debt problem.

In this respect, I would like to refer to the recent encouraging G-7 communiqué of Naples, which states:

> Where appropriate, we favor a reduction in the stock of debt and an increase in concessionality for those countries facing special difficulties.

I understand this to mean that the G-7 may now be willing not only to start reducing debt for relevant countries by 50 percent under the Toronto terms, but even to go beyond 50 percent for some countries.

Beyond the needs for debt-stock reduction and concessional aid, exit rescheduling might be desirable. A clean-cut solution to the debt problem that keeps debtor countries away from continual rescheduling and debt negotiations for several consecutive years can help the growth process, as experienced by Indonesia in the late 1960s and the Latin American countries after the debt crisis in the 1980s.

I share Mr. Shaalan's observation that there are no reasons why multilateral institutions should not extend write-downs, as done by commercial banks. I am also encouraged by Mr. Smee's view that there is nothing wrong with multilateral institutions doing so. I have much sympathy for his contention that such a write-down is already being practiced by the Fund through the ESAF. Unfortunately, that is not the way others perceive the ESAF; they do not see the ESAF as a debt forgiveness exercise. I am aware of the prevailing position of the major shareholders on this matter, who want to maintain the financial standing of these institutions. This position is reflected in the interventions of their chairs in the Board today. As in all cases, nothing is permanent, as is attested by the acceptance of multiyear rescheduling arrangements, interest rate reductions, and partial debt forgiveness, which, in the beginning, were all taboo, as Mr. Smee noted in his remarks. I am sure that the time will come when even the major shareholders will accept debt writedowns, along with the commercial banks and donor countries--especially as such a provision exists in the Articles of Agreement of the Fund. In the meantime, efforts to resolve arrears through support groups of donor countries--such as in the cases of Cambodia, Viet Nam, and other countries--should be intensified.

While substantial debt reduction is a necessary condition to allow countries to begin to devote their resources to development, debt reduction alone will not result in economic growth and development. In the light of poor economic policies that some countries had pursued in the past, they will need to put in place sound economic policies to restore growth and external viability. In particular, they should seek to restore macroeconomic stability, through fiscal and monetary discipline, if they are to create the necessary conditions for growth. Equally important is that the international community increases the supply of concessional funds and helps create a more favorable international economic environment, so as to enable these countries to achieve high rates of economic growth, without relapsing into a new debt crisis.

Mr. Wei made the following statement:

I join previous speakers in commending the staff for preparing such a comprehensive and informative set of papers for today's discussion. In brief, the debt situation and developments in recent years continue to be mixed. On the one hand, it is encouraging that continued progress has been made in restructuring the middle-income countries' debts. The debtors' strong commitment to the reform and adjustment programs has been the key contributing factor to this impressive achievement. On the other hand, it is regrettable that progress has been consistently slow in solving the severe debt problems of the low-income and poorest countries, which again gives rise to grave concern. A resolution of the global debt problem still remains quite remote, and solving the remaining debt issues will take longer than anticipated.

I share many of the views expressed by both the staff and previous speakers. During recent years, there has been no significant breakthrough in addressing the persistent debt problems of the low-income and poorest countries, which are obviously much harder to handle, and involve large financial resources. Debt-reduction efforts, unfortunately, have not been successful, owing not only to difficult domestic situations, but also to less flexible terms in the debt-reduction plan. Indeed, to expedite settlement of the mounting debts of low-income countries, a more meaningful reduction in multilateral official debts--including providing more concessional financing--is required.

In this connection, we welcome the World Bank's decision to add additional resources to the debt-reduction facility for IDA-eligible countries. However, serious concern remains over the continuing decline in official development assistance in both absolute terms and as a percent of those industrial countries' GDP. Even more worrisome is that prospects for official development assistance are expected to be discouraging. Therefore, attention must be paid to this tendency, which is inconsistent with solving debt issues--and much more effort is required to arrest this tendency quickly in order to increase financial assistance on concessional terms to the low-income and poorest countries.

Regarding the role of multilateral institutions financing developing countries, given that debts to multilateral institutions account for 43 percent of the total debt of the low-income countries, the roles played by these institutions need to be reviewed. We welcome a more open debate on any initiatives in this regard, including discussion of the possibility of debt forgiveness by the international institutions.

However, having carefully evaluated the staff's views, I am persuaded that the institutions should emphasize the effectiveness of financially supported programs rather than debt relief. We would agree, in this context, that debt forgiveness offered by the multilateral institutions does not serve the interests of the institutions.

With respect to spontaneous capital inflows as a way to finance the developing countries, we agree that these types of inflows are conducive to alleviating the financing demands of developing counties, but mostly to the middle-income developing countries. However, the role of capital inflows in solving the debt problem cannot be overemphasized. In fact, the middle-income countries in the Asian and Latin American regions have been the main focus of these inflows, and much smaller flows have been directed to the low-income and poorest countries.

Furthermore, it is right to point out that there has been a distinction between long-term investment capital inflows and short-term speculative inflows. The latter would result in destabilizing effects for macroeconomic policy and worsening debt problems when capital flights occur, largely because of the possible rise in interest rates in the industrial countries. The recipient counties, therefore, must be made fully aware of this, and consistent efforts need to be made to attract as many non-debt creating flows as possible.

In an attempt to minimize possibly adverse outcomes, we would support the suggestion that a fast-disbursing, very short-term facility be established to buffer any destructive capital flight and alleviate the debt burden. The Fund is also called upon to respond quickly to this adverse development, if it happens. I also share the staff's warning about the need to strengthen prudent debt management in the recipient countries.

The staff has clearly illustrated the limits of official export credit financing in the overall financing of developing countries and in solving the debt problems currently facing the majority of debtor countries--although the potential role of such credits in improving the ability of those countries to earn foreign exchange cannot be neglected. In this area, it is essential that official export credits be considered as a component of the overall debt reduction strategy. In order to avoid the mistakes of the debt crisis, much work needs to be done to strengthen collaboration with multilateral institutions and to incorporate this area of increasing finances into the adjustment programs supported by the institutions.

The steady headway made in finally ameliorating the debt problem and in financing the middle-income developing countries is encouraging and welcome. Meanwhile, we urgently need to accelerate a solution to the debt problems of the low-income countries, which have been--and still are--heavy burdens to those countries in the process of adjusting their economies under very difficult situations.

Mr. Toé made the following statement:

I commend the staff for the comprehensive and informative documentation prepared for our review of the debt strategy. Like previous speakers, we are encouraged by the continued progress being made under the debt strategy, as evidenced by the conclusion of a large number of debt-service reduction operations with commercial banks and the graduation from Paris Club rescheduling by several middle- and lower middle-income countries and some low-income countries.

Notwithstanding these encouraging developments, there is no room for complacency, as a large number of low-income countries, and indeed some lower middle-income countries, continue to face extraordinary debt-servicing difficulties, with no relief in sight, in spite of the more concessional rescheduling terms adopted by Paris Club creditors.

As this chair has stated all along, for the severely indebted countries, bold and imaginative initiatives under the debt strategy, including a substantial reduction in the stock of their debt, is needed if these countries are to be given the possibility of growing out of their debt and re-establishing normal relations with their creditors.

We therefore welcome the information that, following the recent Naples Summit of the G-7, Paris Club creditors have intensified their consideration of the modalities of stock-of-debt operations, and that further discussions are planned for later this month. In view of the decline in net flows of official development assistance, the bleak prospects for an early reversal of that trend, and the increasing share of multilateral debts in the poorest countries' total external debt, we believe strongly that a deeper reduction than the illustrative 50 percent reduction mentioned in the staff papers is called for. In this connection, we are pleased to learn from Mr. Dorrington that the U.K. authorities are pressing for immediate stock-of-debt reductions of up to 80 percent for the poorest, most indebted countries with good track records under Fund and Paris Club agreements. We would urge other Paris Club creditors to support the U.K. authorities' efforts in this undertaking.

On the issue of debt forgiveness by multilateral institutions, I can associate myself with the comments made by Messrs. Shaalan and Sirat. For the Fund, there is the hardship provision in the Articles of Agreement--which has never been used--and the rights accumulation approach, which, in my view, should be extended to countries other than the original 11 countries that had financial obligations to the Fund overdue for six months or more at the end of 1989. There is a prime candidate in our constituency--Zaïre. It would be helpful for the rights accumulation program to be extended so that Zaïre could benefit from it once it settles its political situation. I agree also with some previous speakers that there is a delicate problem involved regarding debt forgiveness by the World Bank and the African Development Bank. For other international financial institutions, in particular the regional development banks, the door should not be closed to these institutions' cleaning or strengthening their portfolios, including by providing debt relief to the poorest countries or, at a minimum, by maintaining positive flows of concessional resources to these countries.

Mr. Oya made the following statement:

With regard to commercial bank debt restructuring, I welcome the significant progress made over the past year. It should be noted, however, that many countries, especially low-income countries, are still facing serious debt problems in relation to commercial banks. I expect the Fund to continue to play a major role in this respect, through advising authorities to implement sound macroeconomic and structural measures, and through providing necessary resources for the restructuring of bank debt in a timely fashion. In this respect, Mr. Sirat raises an interesting point on a possible financial mechanism of set-asides and additional resources to ESAF-eligible countries. I look forward to hearing the staff's answers to his question.

I will comment on official bilateral debt restructuring. On early debt-stock operations, the staff says that for countries that have already made significant progress under Fund-supported programs, early debt-stock operations are now clearly appropriate. My authorities emphasize that, at this stage, it is too early to consider early debt-stock operations. They believe that debt-stock operations should be initiated after confirming three years of good performance by each debtor under a Fund arrangement and rescheduling agreement. My authorities also believe that early debt-stock operations should be considered only after a careful review of the effect of debt-stock operations in each country.

With respect to the extent of debt reduction by bilateral creditors, the staff says that a number of countries will require substantially deeper reductions by bilateral creditors to bring debt-service profiles to manageable levels, even in the context of ambitious adjustment programs. My authorities can go along with this view. They insist that eligibility for debt reduction of more than 50 percent should be limited to those countries that are facing special difficulties arising from a heavy debt burden and for which the granting of deeper debt reduction can be justified in light of their serious efforts at achieving good economic performance under Fund-supported programs.

Concerning the relationship between debt reduction and new money, my authorities' long-standing policy is to suspend the provision of financial assistance to those countries that have been granted exit restructuring under debt-stock operations. That said, my authorities agree with the staff that those countries should strengthen their efforts aimed at bringing savings-investment balances in line with available external financing and at attracting non-debt creating private sector flows.

Mr. Rouai stated that the overall debt situation was more manageable at present than it had been in the past, but that improvement should not lead to complacency. The increasing reliance on private financing was challenging, requiring from the authorities a continued strong adjustment policy, in order to sustain a supportive and sound macroeconomic environment. It also necessitated careful monitoring of private external borrowing and the establishment of appropriate prudential regulations. He welcomed the staff's emphasis on stock-of-debt reduction for low-income countries, as a way to deal with the debt overhang of the poorest countries that continued to follow strong adjustment policies.

Ms. Srejber commented that, with respect to the discussion on page 21 of the main paper on the pricing of risk in the markets, the pricing of risk in bond markets was seen not only in the level of interest rates paid, but also in terms of the volume of bonds that could be issued. She wondered why that fact had not been reflected very well in the paper. Investors were often allowed to invest only in issues that were approved, and in an authorized amount that could not be exceeded regardless of the rate of interest that was being offered.

The staff had remarked that the reaction of the secondary markets to debt-reduction operations had been slow in coming, Ms. Srejber recalled. Knowing the psychology of investors, that should not come as a surprise, in her view. Typically, investors first became concerned; then stopped buying; the word went around to other investors to stop buying; and then, as market participants suddenly began to say the same thing to each other, an abrupt reaction followed. That experience was not unique to the developing countries.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

The staff representative from the Policy Development and Review Department commented that he had been glad to see that most Directors had found the discussions in the staff paper on multilateral debt to be self-evident. As Mr. Shaalan had surmised, that subject had been raised primarily by the nongovernmental organizations. The staff had believed that it would be better to deal with that question head on in the Board. In discussing that issue, it was important to get a handle on the scale of the problem--and the staff believed that it was quite limited. However, by raising the subject in the way the staff had done, the opposite judgment might have been made by some speakers. It needed to be borne in mind that, while debt to multilateral institutions raised problems for a few countries, and some of the multilateral development banks had large claims on nonconcessional terms outstanding, the Fund and the Bank had been relatively successful, over time, in converting their portfolios to concessional terms.

If the problem of multilateral debt itself was quite limited, that of debt to the Fund was an even smaller problem, the staff representative observed. It was largely limited to some of the cases of prolonged arrears. There, perhaps, the Fund might have to review the available instruments to ensure that those countries could effectively exit from their debt difficulties.

The staff had been making every effort to incorporate Russian and the older Soviet claims into the data on debt, and it had tried to ensure that the coverage was as complete as possible, the staff representative stressed. However, the reporting of debtors to the World Bank's Debtor Reporting System, on which the staff had relied heavily in the papers, was often incomplete. In some of the countries of the former Soviet Union, in particular, there have been significant failures to report full data to the World Bank. For example, the staff would not have caught Georgia--to which Mr. Mozhin had made a reference--in the net, given the timing of its borrowings. The staff had also been making efforts to obtain full data from the Russian authorities on their claims on other member countries. After correspondence with very senior levels of the Russian Government, the staff mission currently in Moscow was expecting to receive, with Mr. Kagalovsky's help, full information on those claims.

It had been mentioned by Mr. Mozhin that the staff had not covered the debt problems of countries of the former Soviet Union specifically in the paper, the staff representative concluded. It was indeed a serious problem that needed to be analyzed, but it was complicated and difficult for the staff to do so, because it was often unclear what the claims were on both sides, the terms of the debts, what was government debt and enterprise debt, and whether various claims were regarded as legitimate by both parties. The staff made an effort to obtain as clear a picture as possible of the debt situation in its country work, and to report fully on it to the Board. However, at the current juncture, the staff had not believed that it had the time to treat that important topic in the current papers with the attention that it deserved.

Another staff representative from the Policy Development and Review Department stated that the Fund and the World Bank had taken different approaches in assessing the severity of the debt burden of individual countries. The Bank used the concept of severely indebted low-income countries, which was based on debt/export ratios and per capita incomes. To take account of the concessionality of some of the debt, which was a large part of the total debt in the case of the low-income countries, the Bank had recently introduced the concept of net present value of the debt/export ratio. That was used to rank countries from the most indebted to the least indebted. The World Bank also used the threshold of 220 percent. Countries above that ratio were considered severely indebted, countries below that ratio were considered moderately indebted. It was a useful tool for identifying in the first instance a certain set of countries that were heavily indebted and that needed to be looked at for potential debt problems. In fact, most of those countries had severe debt-servicing difficulties, although some--for example Ghana--did not.

The approach used in the staff paper had a more operational base, the staff representative explained, in the sense that the staff had looked at the low-income rescheduling countries, countries that had evident debt-servicing difficulties and had come to the Paris Club for rescheduling. That did not include some countries that the World Bank had not identified as severely indebted, but that nevertheless had required Paris Club rescheduling. The staff had not focused in particular on some countries that were severely indebted--such as Somalia and Sudan, for example--that had not had any recent Fund-supported programs, but which were expected to come back to the Paris Club eventually to resolve their debt problems.

The results of the approaches of the Fund and the Bank were presented in the annex of the background paper on official financing, on page 44, the staff representative pointed out. There were two lists and two tables, with a cross-reference between the World Bank classification into severely indebted low-income countries and the Fund's classification of Paris Club low-income rescheduling countries.

While the Fund and the Bank had different perspectives in classifying the low-income, heavily indebted countries, there was really no difference between the Bank and the Fund in the way they looked at individual countries, the staff representative stressed. The Fund staff continued to work closely with the World Bank, and the staffs of both institutions generally came to the same view on particular country situations. The fact that the two institutions had come up with two lists should not give the impression that there was a basic disagreement between them. Both agreed on the need for debt reduction on the basis of country-specific medium-term scenarios.

The Bank did not see its list of severely indebted low-income countries in any way as an eligibility list for debt reduction, the staff representative explained. It did not make any prescriptions about possible overall degrees of debt reduction. While the Bank made some hypothetical calculations as to what kind of measures would lead to a certain reduction in the net present value ratio--as the Fund did--those calculations were not prescriptive. Neither institution made an attempt to derive a definitive list of countries that would require a definitive degree of debt reduction;

rather, it was recognized that countries would need to be looked at in a country-specific manner.

It needed to be borne in mind that the net present value concept was a good preliminary indicator, but that it had serious limitations, the staff representative acknowledged. Conceptually, it would have been convenient to have the present value of all future exports as a denominator, but because of data limitations, the World Bank currently used historical averages of exports over the period between 1990 and 1992. That could severely overestimate the net present value ratio. The example of Uganda, with recently rapidly increasing coffee prices, was a good one. The net present value concept also did not take into account the nature and the terms of future financing flows; therefore, there was the need for country-specific approaches.

The point had been made by Ms. Lissakers that private inflows should be included in the denominator of the debt/export ratio, as they contributed to a country's debt-servicing capacity, and that as wide a measure as possible was preferable, the staff representative recalled. In fact, for Tanzania, where private inflows were significant and were expected to be reasonably stable, the ratios presented in the paper had included private transfers.

It was true that flow reschedulings--the rescheduling of debt service--provided a greater degree of cash flow relief, with the same coverage, and the same degree of concessionality as debt stock relief, the staff representative concluded. Such flexibility was indeed welcome and very much needed for many countries in the initial period, as they coped with arrears on nonrestructurable debt. However, the debt-service would rise--and, in fact, become larger--under continued flow reschedulings than it would under an initial stock-of-debt operation, because the interest that was being consolidated and capitalized continued to accrue at the nonconcessional rate. Thus, the advantage eroded over time. How fast the two debt service schedules would cross over depended on the underlying debt service profile. In any case, as the simulations had shown, the difference between a flow rescheduling and a stock-of-debt operation in the cases that had been put forward as good candidates for early stock-of-debt operations were relatively small relative to the net overall resource transfers.

A third staff representative from the Policy Development and Review Department stated that the situation of certain low-income countries with relatively large commercial bank debts had been complicated by market speculation that had caused the secondary market prices of the debt to be bid up. As a result, in several cases, it had become prohibitively expensive to effect a straight debt buy-back; therefore, some type of debt or debt and debt-service reduction operation might be required instead. In carrying out such an operation, the key parameters were to establish what the country's debt-servicing capacity would be over the medium term, and assess the available resources. Mr. Sirat in particular had raised the question of what the Fund's role might be in the financing of those operations. He had suggested that Fund general resources might be used to complement an ESAF agreement in order to provide the required additional resources to finance a debt and debt-service reduction operation. Another possibility would be to finance such an operation in the context of the ESAF itself, assuming that that could be accommodated under the ESAF's current access limits and that the balance of payments need was established.

It was the widely held view of market participants that bonds had seniority over bank debt, a perception that had its roots in the previous experience during the debt crisis, when bond debt had been serviced while bank debt had not been, the staff representative went on. Of course, that situation could change as the relative importance of bond debt increased for a number of countries.

The points that had been raised by Ms. Srejber about the pricing of bonds were well taken, the staff representative concluded. The presentation in the staff paper had been based on an observation of market behavior. In its discussions with market participants, the staff had mentioned that bond prices often seemed not to reflect fully the information about particular countries in the market. The staff had sought to test that proposition in a more rigorous fashion.

Mr. Kafka remarked that he wondered whether, in monitoring capital inflows, the staff expected to require countries to ask for the Fund's permission to borrow in individual instances, or whether the staff would only come up with general rules designed to ensure a proper prudential stance.

The staff representative from the Policy Development and Review Department replied that the latter was what the staff had in mind. The staff had intended to monitor capital inflows in the more general context of gathering information on the flows and their magnitude.

Mr. Sirat said that, in any published version of the staff paper, the paragraph on the seniority of bonds should be rephrased. As it was at present, it could be misleading, in particular with regard to the nature of bonds issued by private enterprises. In the same vein, Tables 3 to 9 in the annex on the effects of the stock-of-debt approach could be explained in more detail, because they might raise unreasonable expectations about such operations as they were at present. For example, the baseline scenario showed a relatively large financing gap, which almost disappeared following a stock-of-debt operation with the Paris Club. Perhaps a step was missing there.

He had appreciated the staff's remarks about the possibility of financing full-fledged bank restructuring for ESAF-eligible countries, Mr. Sirat went on. Perhaps such a signal could be transmitted both to the banks and the countries concerned. The potential to finance not only buy-backs but also other debt restructuring arrangements for ESAF-eligible countries needed to be made clear.

The staff representative from the Policy Development and Review Department commented that it was the staff's view that access policy under the ESAF was flexible enough to allow somewhat greater access for countries with large balance of payments needs--including a need to do a debt-restructuring operation--than for countries in which the balance of payments need was less. From that perspective, resources could be made available indirectly through the ESAF to strengthen countries' reserves, thus putting the country in a position to finance a debt restructuring operation. Such resources would be in addition to other funds that might be made available for that purpose--for example, from the IDA debt-reduction facility, and from bilateral donors--that had been helpful in a number of other cases. The staff was proposing neither the creation of a new ESAF window to finance debt reductions, nor the setting up of a pool of resources that commercial banks might see as an encouragement to bid up the secondary market prices of debt. Such deals would have to be done on terms that were consistent both with resource availability to the country and its debt-servicing capabilities in the future.

The Chairman commented that the Fund already had all the mechanisms it needed to go a long way in the direction that Mr. Sirat had suggested without compromising or embarrassing the Fund. The only thing needed was a convincing case in which to apply the flexibility that the Executive Board had provided it with.

Mr. Sirat added that increasing access to the ESAF at the current juncture might not be needed. Perhaps using mixed credits might be more efficient. He wondered whether the Fund was already in a position to support, with others, restructuring operations involving discounted bonds, par bonds, and the like, as well as debt buy-backs, for eligible countries.

The staff representative from the Policy Development and Review Department explained that the Fund was not financing buy-backs or debt reduction operations direct through the ESAF, or with ESAF resources. ESAF resources were to provide balance of payments support to a country. The guidelines on access to the ESAF were laid down in the ESAF decisions. One of the factors that determined ESAF eligibility was the country's balance of payments need. One of the factors that was material in the balance of payments need would be the need to conduct a debt-reduction operation. It was not a question of the Fund's financing specifically and explicitly through ESAF resources a debt-reduction operation; rather, the Fund would help the country, as a complement to the IDA debt-reduction facility and support from other bilateral donors, to finance such an operation.

The staff had not proposed combining resources under the ESAF with a limited amount of resources under a stand-by and/or extended arrangement for low-income countries for the purpose of a debt-reduction operation because such an approach would involve financing a debt-reduction deal for a country that needed assistance on very concessional terms with money that was on rather unconcessional terms, the staff representative pointed out. In fact, resources from the General Resources Account would not seem to be the appropriate form of financing precisely for those low-income countries in which a substantial reduction of the debt was needed.

Mr. Sirat said that he wondered whether a country that needed collateral to guarantee principle or interest repayments on discount or par bonds would qualify as having a balance of payments need that could be supported through the ESAF. Moreover, if the resources to cover that need were not available under the ESAF, he wondered whether resources under a stand-by or extended arrangement could be mixed in with ESAF resources.

The staff representative from the Policy Development and Review Department replied that the Fund's role was catalytic, and the Fund could not finance a country's entire balance of payments need through the ESAF. The balance of payments need would be met, it was to be hoped, through the efforts of a number of participants, not just the Fund. The staff would see obstacles in moving immediately to add expensive money--from the General Resources Account--for the purpose of financing a debt reduction operation. While it was not absolutely ruled out, in general it would be inappropriate. It was to be hoped that some bilateral money, on very concessional terms, catalyzed by the Fund's involvement, would be forthcoming for that purpose.

The Chairman made the following summing up:

Executive Directors noted the substantial progress made in resolving the debt problems of middle-income developing countries. Over the preceding year, significant further advances had been made in resolving commercial bank debt problems, with several countries concluding restructuring agreements with their commercial creditors. The progress achieved in that regard reflected the strength of the economic policy programs pursued in those countries and the flexibility of the menu approach, which allowed the specifics of each bank debt package to be framed with an eye to each country's needs. Progress had also been made on official debt. Most middle-income countries had now graduated from the Paris Club rescheduling process, or were expected to do so at the end of their current consolidation periods. The resolution of middle-income developing countries' debt problems, in turn, had facilitated renewed access to spontaneous private financing for many of them. Directors considered that for the relatively few middle-income developing countries that still needed to address their commercial debt problems, progress would require the implementation of strong economic policies and a willingness on the part of creditors to show flexibility in response to the circumstances that each of those countries might face.

Directors observed that the middle-income developing countries were the major beneficiaries of the sharp increase in spontaneous private market financing experienced between 1990 and

1993. Despite the sharp market correction in early 1994, Directors saw more recent developments as providing grounds for optimism regarding the sustainability of substantial capital inflows. However, they noted that the ability of countries to retain significant access to international financial markets depended on the countries' maintaining strong policy stances.

In contrast to the more favorable situation faced by many middle-income developing countries, Directors pointed to the difficult problems that many low-income countries continued to confront. Many of those countries had large debts to official creditors. Some of them also had sizable commercial bank debts that needed to be restructured. Moreover, as a group, low-income developing countries had achieved little in the way of access to private sources of financing. To deal with those countries' problems, Directors emphasized the importance of establishing a sound and stable economic policy environment, but they also stressed the need for supportive actions on a number of fronts.

Directors observed that, with the Paris Club's phased approach to debt rescheduling--involving reschedulings of debt-service flows on enhanced concessional terms--those creditors had provided substantial assistance to a number of low-income countries in meeting their external financing needs. Nevertheless, Directors noted that many of those countries still faced large overhangs of bilateral debt to official creditors that could only be removed by stock-of-debt operations, as envisaged under the menu of enhanced concessions agreed by the Paris Club in 1991. Directors welcomed the further steps considered by the Naples Summit of the Group of Seven industrial countries.

Directors urged Paris Club creditors to implement at an early date debt-stock operations for countries that had established track records of performance under Fund-supported programs and rescheduling agreements. Directors noted that most of the low-income developing countries would continue to require large net transfers from abroad on highly concessional terms to satisfy basic import and development needs, and it was essential that debt-stock operations be carried out in a way that would not jeopardize those flows.

In the case of commercial bank debt, the low-income countries with particularly severe debt burdens also had limited resources, making it likely that financing the cost of simple debt buybacks would not be feasible in many cases. At the same time, secondary market prices of their bank claims might not be reflective of the debt-servicing capacity of those countries. In those circumstances, Directors felt that creditors would need to show additional flexibility by being willing to accept terms more explicitly tied to an assessment of those countries' limited debt-servicing abilities. They also stressed that sufficient resources needed to be available on appropriate terms to support bank debt operations.

Directors expressed concern about the decline in the net bilateral aid flows recorded in the preceding year. They emphasized that there was considerable scope for improving the targeting of aid to the poorest countries, for example, by reducing the use of aid as an instrument of export competition. Many Directors underscored the fact that recipient countries needed also to reinforce their efforts to increase the effectiveness of their use of bilateral aid.

Directors noted that officially supported export credits remained a key source of official bilateral assistance, particularly for certain developing countries and for economies in transition. They agreed that, while access to such credits could provide an important step toward establishing creditworthiness, they were not well suited to substitute for general balance of payments support, especially over the medium term. That suggested that developing country authorities should carefully manage their debt outstanding to export credit agencies. Directors also encouraged export credit agencies to make more intensive use of recent innovations in risk management, such as closer coordination of their lending with other agencies and multilateral institutions, and discussions on the effective use of export credits with recipient countries. Directors generally considered that the potential benefits of escrow accounts needed to be carefully balanced against the danger of proliferation of such arrangements and reduced access to nonsecuritized lending.

Directors observed that the multilateral institutions had played a central role in supporting the economic adjustment efforts of developing countries. The Fund and the World Bank, in particular, had achieved a pronounced shift toward lending to low-income countries on highly concessional terms. In the period ahead, Directors saw the multilateral institutions, especially the Fund and the World Bank, as being called on to play an even greater role in the financing of the developing countries and the economies in transition, and in establishing the framework for support for other creditors and donors, including by improving the public availability of, and understanding of, information on current trends in flows of financing. Given that central role in mobilizing resources, Directors stressed that debt forgiveness by the multilateral institutions was not desirable and should not be considered. Debt forgiveness would seriously impinge on the effectiveness of the Fund by undermining its preferred creditor status and the revolving nature of its resources. At the same time, Directors stressed the importance of ensuring that lending to low-income developing countries by multilateral institutions, especially the regional institutions, be provided on concessional terms in support of strong economic policy programs. It was also observed that the multilateral institutions should continue to work with members that had payments arrears to those institutions with a view to helping them overcome those problems.

It was agreed that, after the Annual Meetings, an informal meeting would be scheduled to discuss the possible scope and role of periodic meetings with participants in financial markets to exchange information on global and systemic financial trends.

3. WORLD ECONOMIC OUTLOOK

The Executive Directors continued from the previous meeting (EBM/94/81, 9/8/94) their consideration of a staff paper on prospects and policy issues related to the world economic outlook (EBS/94/155, 8/10/94). They also had before them a statistical appendix (EBS/94/156, 8/11/94), boxes and annexes providing background material (EBS/94/158, 8/16/94), a package of charts and tables on world economic and market developments (EBD/94/149, 9/2/94), and a report on foreign exchange and financial markets in July 1994 (EBD/94/141, 8/19/94).

Mr. Mesaki recalled that many Directors had expressed views on monetary policy in Japan at EBM/94/81. While some Directors had said that there seemed to be room for further monetary easing, more Directors had felt that a wait-and-see stance would be appropriate. In fact, the latter view was very much in line with the Chairman's summing up at the conclusion of the recent Article IV consultation with Japan (EBM/94/69, 7/27/94). Both he and his authorities were puzzled why, therefore, the staff had advocated further monetary easing in many pages of the world economic outlook paper in spite of the result of the July 27 discussion. Time constraints had presumably played a role, but the discussion at EBM/94/81 served to confirm the view that revisions were necessary. Therefore, his authorities strongly expected that the staff's description of Japanese monetary policy would be revised appropriately.

The Chairman said that Mr. Mesaki's point was well taken. A range of views had been expressed at EBM/94/81, and his summing up would need to reflect those views carefully. That task was made difficult by the fact that many were of the view, even if expressed with prudence, that a further appreciation of the yen would be dangerous for the recovery in Japan and for the world economy more generally. It followed from that view that monetary policy might be expected to produce a signal of the determination to avoid a further appreciation.

Mr. Mesaki remarked that the views of his authorities on preventing an appreciation of the yen through the use of monetary policy were well known. Monetary policy should be conducted taking the full range of internal and external conditions into account. The key requirement at the present stage was development in the economy as a whole.

The Chairman noted that the language of the world economic outlook paper suggested that there was room for a further reduction of interest rates; it did not indicate whether that room should be utilized.

The staff representative from the Research Department, Mr. Larsen, made the following statement:

> Let me begin by addressing those comments or questions that relate to the short-term forecasts presented in the world economic outlook, and revised in the presentation of the Economic Counsellor at the beginning of the session yesterday.
>
> Ms. Lissakers refers to the upward revision to the growth projections for some industrial countries that had been undertaken since the May 1994 world economic outlook and asked which specific developments in key economic variables had led to the more optimistic assessment. Other than referring to the clear signs that both business and consumer confidence obviously are improving and that the actual data for the second quarter are stronger than expected, I think it would be difficult to point to any specific event that has occurred since the spring as a possible explanation. One may, therefore, ask, as Ms. Lissakers did, whether there were economic indicators at that time that already in the spring pointed to the possibility of a stronger pickup, especially in Europe. It will be recalled, however, that most information at hand at that time pointed to continuing weak conditions in Europe, at least through the end of 1993. Although some indicators began to turn up at the beginning of the year, there was still considerable doubt, not least among the national authorities, about the robustness of these early signals. The staff did, however, expect the recovery gradually to take hold in the course of the year, which in retrospect now seems to be materializing, albeit slightly faster than expected at that time. I would still note, though, that the most important signal at that time--and here we are talking about the period March-April 1994--which perhaps was underrated at the time, was the significance of the sharp rise in long-term interest rates since the beginning of the year.
>
> At the time of the world economic outlook discussion in April 1994, and indeed also in the published May 1994 World Economic Outlook, the staff did emphasize the role of stronger than expected growth in the United States as having contributed to this development, but it was not as clear at the time as appears to be the case now that the rise in interest rates that took place starting in January 1994 also reflected a strengthening of activity outside the United States, and particularly in Europe. In the current world economic outlook, of course, the relationship

between the recovery, revision of growth expectations, and the pressure on long-term interest rates has been given considerable attention.

Mr. Kiekens, in his statement, notes the difference between the staff's growth projections for Japan for 1995 and the growth projections for the consensus of private forecasters. As shown in supplementary Table 1 to the background document for yesterday's World Economic and Market Developments (WEMD) session, the consensus forecast at the present time is for growth to recover only very slowly to just 1.75 percent in 1995 compared with the staff's forecast of 2.5 percent growth next year. As indeed stressed by the Economic Counsellor, it does appear that the consensus is a bit behind the curve at present, and it is worth emphasizing the disagreements among the private forecasters, which are reflected in a large standard deviation between the forecasts. During the period ahead, therefore, we expect the consensus forecast to be revised up significantly. As for the staff's forecast for Japan, we would not be surprised to see further upward revision in light of recent indicators, even though the central forecast naturally also will need to take due account of any downside risk that may still exist in the case of Japan, especially that related to the effects of the strong yen. I will come back to those effects a little later.

I might add that the discussion of the near-term outlook for Europe, and Japan in particular, and indeed the projections will need to be looked at carefully in the days that follow in the light of the most recent information, including of course the most recent indications that growth in Germany and France was also a bit stronger in the second quarter than had been expected. As we say in the world economic outlook, at this point in the cycle further upward revisions would not be unusual.

Mr. Kiekens also asked the staff to comment on the role of external or exogenous factors versus the role of domestic policies in explaining the revisions to the growth projections for the developing countries. In the world economic outlook, looking at some of the more important countries, it is clear that both external and internal factors have played some role in explaining these forecast revisions, albeit to different degrees across countries. In Turkey and Venezuela, for example--countries the Economic Counsellor referred to yesterday--domestic policy-related difficulties seem to be the main reason for the downward revisions. For other countries, there are exogenous factors that seem to play a role. In the case of Pakistan, for example, there is a downward revision due to crop failures. In the case of countries with upward revisions to the growth projections--Korea, China, Brazil, and Argentina--we are also looking at a variety of both domestic and external factors.

Several Directors felt that the growth projections for Africa are somewhat optimistic. I fully agree that they may appear optimistic in light of past difficulties. We should also remember that the projections for program countries are conditional upon the firm implementation of the stabilization policies and reforms agreed under the programs. Experience shows, unfortunately, that this is not always the outcome. There is also the risk that the effects of a program may not materialize quite as rapidly as hoped or that unforeseen exogenous events may interfere with the process of reform and recovery.

The many reasons to be cautious about the prospects for Africa clearly point to the need to qualify the projections that are presented appropriately, and we shall do so in the published version to take into account the concerns of Executive Directors.

There are, nevertheless, a number of reasons to expect the near-term outlook for Africa to improve somewhat, and these positive developments also need to be duly recognized. Just to mention some of the most important, there are changes in policies in general in Africa that seem to be going in the right direction. One particularly important example of such improvements in the policy environment is the growing trend toward the establishment of more realistic and more sustainable exchange rates in recent years. This applies not only to the CFA countries. I should, of course, also emphasize, in the context of the world economic outlook, that the external environment has become substantially more favorable. Commodity prices are recovering and the European export markets for African exporters are growing more rapidly. It should be noted here that this is not just a question of the effects of the improvements in the external environment on export earnings, but that the stronger external environment should also help to increase the chances of success of domestic reform efforts in Africa. This was a point that was discussed extensively in the analysis presented in the May 1994 World Economic Outlook.

I would also like to emphasize that growth rates of 4-5 percent or even higher are by no means exceptional in Africa. This can be seen from the historical growth rates in individual countries shown in Table A6 in the statistical appendix. What is unusual and somewhat uncertain is whether economic performance will strengthen in a sufficiently large number of countries to raise the average growth rate. In the light of the positive developments I have referred to, however, this would not seem an unrealistic expectation, even though the performance of individual countries is likely to continue to differ markedly.

Some of these points can probably usefully be strengthened in the text and we shall attempt to do so before publication. Also with reference to Africa, Mr. Jones asked about the net effects of the result of the conclusion of the Uruguay Round agreement. I shall try to briefly summarize some of these effects, which are also discussed in more detail in other papers, including the annex to the May 1994 World Economic Outlook.

The Uruguay Round agreement, when implemented, should lead to some increase in world food prices over time because of the reduced levels of protection of agriculture in the industrial countries. This implies that some food exporters in Africa will benefit, although some net importers of food are likely to see terms of trade losses as a result of this increase in world food prices in the short run. Some other countries may also experience short-term losses as a result of the erosion of trade preferences. So, in the short run, one should not expect any significant positive effect, on average, and some countries may well be adversely affected in the very short run. In the longer term, however, all countries in Africa are likely to gain because of the greater access to industrial country markets and because of the efficiency gains that follow from increased openness toward the rest of the world.

Regarding capital flows to developing countries, there were a number of interesting observations, and I will try to address some of them, including some of those that were raised in the statements.

Mr. Autheman pointed out that these flows have been concentrated on some larger countries, which is correct when one looks at the dollar amounts. Looking at the flows in relation to GDP of the recipient countries, however, it is clear that a very large number of countries have seen increases in flows that amount to over 3 percent of GDP annually in recent years. I think, in fact, as many as 40 countries have experienced flows of that magnitude. Mr. Autheman also rightly pointed out that the flows, important though they are, often are quite small relative to the overall levels of capital formation in most developing countries, and that capital flows in general are not as important for longer-term growth as those factors--particularly domestic policies and performance--that seem to be the main determinants of the capital flows. Even so, one should keep in mind the challenges for economic policies that are associated with a very high level of capital flows and, of course, with the possibility of substantial variations in such flows--variations that may very well amount to several percentage points of GDP from year to year. I believe that this is, indeed, a proper topic for Fund surveillance.

Mr. Ismael, on the same topic, asks whether the pickup of growth in the industrial countries can be expected to provoke a reflow of capital to the traditional markets in the industrial world. This cannot be excluded, of course. However, the world economic outlook projections are based on the assumption that the capital flows will probably diminish somewhat compared to the magnitude seen in recent years, but that they will, nevertheless, remain substantial, and we believe that reflows--that is, the net outflow from the developing countries--would be more likely in those cases where developments in the recipient countries give rise to a change in market sentiment.

Mr. Kafka felt that there should be no objection to the use of capital controls in the short term, as fiscal policy is not sufficiently flexible. Let me make clear here that the world economic outlook does not rule out the possible role of some types of capital controls under certain circumstances. Nevertheless, the staff is concerned about a number of issues related to capital controls. The most important concern has been that capital controls risk being applied as a substitute for correcting policy imbalances. Where the problem is short-term portfolio inflows associated with a large budget deficit and high interest rates, the priority clearly should be on corrective fiscal measures. Even where capital controls may help to stem the inflows, a delay in implementing fiscal measures would certainly also increase the risk of changes in market sentiment, as pointed out by Mr. Mesaki and Mr. Tetangco. A second concern is that imposing capital controls may well send an unfortunate signal to markets about the authorities' commitment to move toward greater reliance on market forces in general and may affect the investment climate adversely. Finally, I think it is also relevant to note, as we do in the world economic outlook, that experience suggests that capital controls are not very effective in stemming capital flows in the face of policy imbalances.

Mr. Mirakhor was concerned about the appropriate policy response in countries that did not have policy imbalances prior to the capital inflows but where the inflows themselves threatened to lead to imbalances. If the inflows in such a case are not primarily short-term speculative flows but perceived to be more stable, it would not seem to make much sense to impose restrictions to limit the inflows of foreign direct investment, because of the cost this would involve in terms of reduced access to foreign technology. In such a case, we believe that the issue is more a question of safeguarding macroeconomic balance, perhaps through some exchange rate appreciation, together with some fiscal tightening relative to what otherwise might have been considered appropriate.

Of course, on all of these issues it is difficult to generalize, and the dilemmas that may arise for a given country may often suggest a need for a broad range of policy actions.

Turning to the questions that were raised by Directors about policy simulations and alternative scenarios, several interesting points came up.

Mr. Kafka made a good case, and a very strong case, for promoting stronger private saving by shifting taxes from income to consumption. It is certainly not unreasonable to assume that it might have some effect, although evidence from life-cycle models would seem to cast some doubt on the magnitude of these effects. I should note here the interesting properties of a new tax block that has recently been added to the staff's econometric model, MULTIMOD, which suggests significant positive effects on output, employment, and saving associated with shifts in taxation away from labor taxes to consumption taxes. This would not be a shift from income taxes to consumption taxes but rather a shift from those taxes that are levied directly on the wage bill, such as social security contributions.

Mr. Wei raised several questions about Japan's export performance in light of the substantial appreciation of the yen and in view of the possibility that these effects might be an obstacle for the recovery. Indeed, there is no doubt that the appreciation of the yen has very substantial negative effects on Japan's export performance. Real exports fell by 1.1 percent in 1993 and are expected to fall by another 1/2 of 1 percent in 1994, compared with market growth for Japan of over 7 percent in both years. So, in the two years together, Japan is losing market shares to quite a considerable degree. Second, the real effective appreciation seen over the past two years of about 30 percent is estimated to have caused a deterioration in the real trade balance equivalent to about 2 1/2 percent of GDP between 1993 and 1995, other things being equal--that is, abstracting from cyclical influences. Because of cyclical influences, the actual effect that one can read from the forecast table is only 1 3/4 percent of GDP. This is still a very substantial negative shock and perhaps helps to set the protracted recession in Japan somewhat in perspective. I think it also underlines the risk, and indeed the possibility, of only a very moderate recovery in Japan because of the continuing negative effects of this appreciation.

Mr. Martinez Oliva questioned the consistency of the second alternative scenario we show in Chapter III on the industrial countries, which combined hysteresis in the labor market with a failure to tighten monetary policy sufficiently during the recovery phase of the cycle. He reasoned that the increase in the natural rate of unemployment assumed in the scenario would put upward pressure on prices and thereby provoke a shift to an even tighter monetary policy. He is, indeed, right that this kind of response would describe the appropriate and desirable policy response in the case of a rise in the natural unemployment rate.

However, what the scenario is intended to illustrate is the consequences of a monetary policy response that fails to take sufficient account of a narrowing of the output gap, a situation that would be aggravated if the natural rate had increased because of persistent effects, and if policymakers had not realized that the structural unemployment rate had increased. With hindsight, I think that we know the dangers of making that kind of mistake from the 1970s, when monetary policy clearly was not tightened enough to prevent a steady rise in inflation during the decade, a period that did see a substantial increase in the underlying or natural unemployment rate.

This last point brings me to Mr. Smee's concerns about the medium-term baseline projections for the industrial countries. He raises the question of whether the medium-term projections adequately reflect all the positive developments that happened in Canada, in particular, but also in the rest of the world, such as low inflation, budget consolidation, trade agreements, and so on. I can reassure him that, in principle, these factors are, of course, taken into account, and we will seek to improve the presentation to make that clear.

At the same time, it is necessary to acknowledge that potential or trend growth, in the absence of these positive developments that already have been taken or are planned for the future, probably would tend to slow in the industrial countries during the period ahead owing to demographic factors, low savings rates and high real interest rates, and the fact that there is little remaining scope for catching-up effects among the industrial countries. This is why the staff does not believe that we are likely to see any substantial rise in trend growth in the future. Instead, we would put the emphasis on these positive developments helping to maintain growth at a more satisfactory pace than would otherwise be the case, and certainly also to limit the risk and magnitude of cyclical fluctuations and strengthen the resilience of countries to adverse external disturbances. But I think we should be very careful in implying that these improvements necessarily would lead to any significant increase in trend growth from the rates seen recently. These points obviously need to be clarified in the chapter.

Now, to go a step further, should we also raise the medium-term projections, as one might infer from some of the remarks made by Mr. Smee, in order to make the policy recommendations more attractive and thereby sell the message? This, of course, is an interesting idea but I believe the staff would be concerned that such an approach would send the wrong message as it would also convey the impression that recovery would be the cure-all for all the imbalances in fiscal positions and labor markets that have been the topic of yesterday's discussion.

Indeed, many times in the past--and especially in the 1970s--policy mistakes came precisely from overly optimistic assessments of potential growth. Making the same mistake now would not increase the likelihood that the current expansion would be used wisely, I believe. I might add here that the reference to "using the expansion wisely" was a phrase that we borrowed from Mr. Smee's world economic outlook statement in April 1994.

In concluding, I would like to refer to some of the many statements that were raised yesterday concerning potential output, and the concerns that were raised that these estimates changed a lot, were erratic, unstable, and so on. Of course, if it were true, this would be somewhat embarrassing to the extent that, notwithstanding all the caveats that attach to these estimates, the staff clearly--as is clear from the documents--attaches a great deal of importance to these types of indicators in the analysis of the fiscal situation, in the evaluation of the cyclical situation, and, of course, in discussing the appropriate course of monetary policy. Unfortunately, many Directors who commented on these issues appear to have gotten the facts somewhat wrong, and Mr. Coe will try to explain how we do in fact derive these estimates. He will also give some illustrations of the extent to which they have been revised in recent years.

Mr. Mirakhor noted that the response of the staff representative to his question closely paralleled the argument in the world economic outlook paper that countries experiencing large capital inflows should address macroeconomic imbalances and forgo capital controls. He wondered what the recommendation would be for countries that did not have macroeconomic imbalances; the problem could not be dismissed merely by suggesting that such countries were not likely to benefit from short-term capital inflows, because there was ample evidence to the contrary. Indeed, some countries had experienced strong surges in capital inflows after a long period of adjustment. He agreed with the staff that "inflows with lead feet," namely, foreign direct investment and the like, were not a source of concern. Other kinds of capital flows had a more speculative, reversible character, however--what might be called "inflows with wings." In fact, surges in the flow of short-term capital often caused the very conditions that led them to fly out of the country.

The Board would soon have an opportunity to discuss one such example, Mr. Mirakhor remarked. After many years of adjustment, with very tight demand-management policy and a performance that had been praised by the staff, Malaysia had experienced a surge in short-term capital inflows in 1993. At first, the authorities had tried to intervene in the market, but they ended up imposing short-term capital controls in January 1994. In his view, the Malaysian experience was not an exception, and he wondered whether the Fund could or should do something about the problem. Both Article VI, Section 3 and Article VIII, Section 2(b) gave the Fund a responsibility to examine ways in which short-term capital flows could be accommodated without causing extreme macroeconomic imbalances in individual countries. In a world of second-best solutions, he wondered whether a universal tax--akin, perhaps, to the Tobin tax--might be appropriate.

The Economic Counsellor commented that it was important to recognize that the staff did not offer generic advice suitable for all countries on how to deal with the issue of capital inflows. A Board seminar on that subject had been held in 1993, and even before that, a fair amount of work had been done by the staff in bringing the issue to the attention of policymakers, including advising on the techniques for dealing with problematic capital inflows. That experience was reflected in the world economic outlook paper. As noted by Mr. Mirakhor, the Board would have an opportunity shortly to discuss the Malaysian experience in detail. At the present stage, he would only note that, in that case, there had been fairly persistent pressure for an appreciation of the exchange rate over a meaningful period of time, and for a variety of reasons, the authorities had not wanted to see the exchange rate appreciate. That was often a problem in many countries, not just developing countries.

Part of the problem was economic and part of it was political, the Economic Counsellor considered. As noted by Charles Schultz, the Chairman of the Council of Economic Advisors in the Carter Administration, "the first role of economic policy is do no visible harm." In other words, letting the exchange rate appreciate as a deliberate act of policy, for example, tended not to sit well with export industries. By contrast, resisting an appreciation through the accumulation of large foreign exchange reserves, perhaps at considerable cost to the central bank, was a quasi-fiscal operation that would not affect directly the economic interest of any particular group. In some countries, pressure from capital inflows tended to overheat the economy, producing domestic price inflation and thereby appreciating the real exchange rate. That process was much less visible, of course, in that inflation was caused by the Government's decision effectively not to appreciate the exchange rate but rather to allow the domestic money supply to rise, because in the end it would not be possible to sterilize completely the capital inflow. The difficulty came when the capital flow was for some reason reversed: if the real exchange rate had been appreciated through domestic price inflation, rather than a movement of the nominal exchange rate, it would not be easy to correct through a nominal exchange rate depreciation.

In general, therefore, he would not disagree with Mr. Mirakhor, the Economic Counsellor said. The issue that Mr. Mirakhor had raised posed difficult policy questions, and there was no unique answer in all circumstances. There were conditions under which the judicious use of capital controls already in place could play some role; reintroducing capital controls for that purpose was generally neither desirable nor viable, however. The importance of the phenomenon suggested that more reflection would be useful. In that context, it was useful to have raised the issue in the context of the world economic outlook, because it was a problem of sufficient dimension, in terms of the number of countries affected, to warrant the exposure associated with the published version of the world economic outlook.

Mr. Geethakrishnan wondered whether it would be fair to infer from the comments of the Economic Counsellor that countries with capital controls should retain them in order to provide flexibility of response, if needed.

The Economic Counsellor said that he would not necessarily draw the same conclusion as Mr. Geethakrishnan. There were costs to maintaining capital controls and costs to the threat of their possible use in terms of the attractiveness of a country to inflows of foreign capital. In moving to remove capital controls already in place, however, the authorities should probably be cautious and judicious about the timing of the process. He agreed with Mr. Autheman that the importance of capital inflows should not be exaggerated, because by and large domestic investment in virtually all countries was financed primarily by domestic savings; the economic policies and conditions that made it attractive to invest typically made it attractive to save as well. Nevertheless, inflows of foreign capital could play an important role in the growth process. In fact, the staff of the Research Department had already done some interesting research on that issue, particularly on the channels of influence. In that regard, foreign direct investment, rather than portfolio investment, was obviously a key factor; the staff had also recently done some work on foreign direct technology transfer effects in the case of Japanese investment in China.

In the case of the Czech Republic, for example, the authorities were faced with a similar problem, the Economic Counsellor remarked. In that case, the authorities were concerned that opening up the enterprise sector fully to foreign investment would lead to a surge in capital inflows, which would cause the koruna to appreciate strongly in real terms and eliminate the competitiveness of key export industries. Consequently, they wanted to proceed cautiously and judiciously with the process of liberalizing and opening up to foreign investment, which appeared to be a sensible strategy under the circumstances. He would expect, nevertheless, that within the present decade the Czech Republic would have a fully integrated trade and capital market regime.

The staff representative from the Research Department, Mr. Coe, made the following statement:

> A number of Directors commented on various aspects of the staff's estimates of potential output, output gaps, and of natural rates of unemployment. I will focus primarily on the staff's estimates of potential, as for a given path of potential output, the gap is completely determined by actual or projected output. Let me start by briefly distinguishing between the staff's historical estimates of potential output based on formal econometric analyses and the staff's estimates and projections that appear in the world economic outlook.

The staff's econometric studies of potential output are based on fairly straightforward production functions relating output to capital and labor input and to a variety of structural determinants of total factor productivity, with labor input being evaluated at the natural rate of unemployment. Most of the recent studies have been done as joint projects between area departments and research staff as supporting material for Article IV consultations and, as such, have been presented to, and discussed with, the national authorities. Most of these studies have also been published.

In many cases, the estimates and projections for potential output that appear in the world economic outlook are closely linked to these econometric studies, particularly if the studies have been done relatively recently. In other cases, however, events such as German unification or benchmark revisions to the national accounts--such as the announcement for Germany today, which, if I understood correctly has raised growth in the past three years by a cumulative 1 percentage point--meaning that the previous econometrically based estimates have to be supplemented to a greater or a lesser extent with more simple estimates of trend output. In all cases, the estimates of potential output incorporate a substantial amount of judgment and country-specific expertise of desk officers; and it is perhaps here, in the incorporation of judgment, that the estimates may appear to spring from a black box. It is important to note, however, that the staff estimates of potential and of natural rates of unemployment are typically very similar to the estimates of the national authorities and to other available estimates.

Let me now turn to some specific comments. Ms. Lissakers remarked on the extent to which the staff estimates of potential output have been marked down and asked if this mainly reflected the recession, or if it represented a less optimistic view of long-term trends. As Mr. Posthumus noted, relative to trend, all economies lose potential during recessions. Europe, Japan, and Canada are just emerging from unusually severe and protracted recessions, and the resulting shortfall of investment from what had been previously been projected implies a lower near-term path of potential output. In Box 5 it is estimated that the cyclical downturn of investment may have reduced the growth of potential in 1993 in the major countries, as a group, by about 1/3 of 1 percentage point. But, as emphasized in Box 5, the rebound of investment in the upswing typically recoups the lost potential.

The largest change to the staff's estimates of potential has been for Japan, which is the only country where the staff now has a significantly less optimistic view of long-term trends. The staff now estimates that potential output growth is about 2 1/2 percent, about the same as in the United States and the other major industrial countries. This contrasts with an estimated potential output growth of about 4 percent in 1987-91. The slowdown of 1 1/2 percentage points is attributable to three factors. By far the most important is a swing in annual labor force growth from 0.9 percent in the 1980s to minus 0.1 percent for the rest of this decade, reflecting the aging of the population in Japan. Including the endogenous effect on capital accumulation, this factor alone reduced estimated potential growth by almost 1 percentage point. In addition, the bubble of the late 1980s resulted in what has turned out to be an overaccumulation of capital and then a subsequent correction. This swing in capital accumulation is estimated to have accounted for the remaining 1/2 of 1 percentage point difference between potential output growth in 1987-91 and now.

Mr. Smee commented on the "dramatic" changes in the estimates of potential from world economic outlook to world economic outlook. Estimates of potential output growth were published a year ago in the October 1993 World Economic Outlook. In general, the estimates published in Box 5 are quite similar, although the comparison is not straightforward, as the estimates are reported for different time periods. A comparison based on the same time periods indicates that potential output growth for 1990-94, on average, was revised down in Germany, France, and Canada by between 1/4 and 1/2 of 1 percentage point, for the reasons discussed in Box 5--that is to say, for cyclical reasons. The estimates were unchanged for Japan and Italy, and the estimates were revised up by 1/4 of 1 percentage point for the United States. For the 1995-98 period--and excluding Japan for the reasons just noted--the growth rates are unchanged for Germany and the United Kingdom, revised up by 0.1 percentage point for the United States, revised down by 0.1 percentage point for Italy and Canada, and revised down by 0.3 percentage points for France, reflecting a reassessment of the path of investment in the medium term.

To put these changes in perspective, it is useful to consider the magnitude of revisions to official national accounts data. Since October 1991, official published estimates of GDP growth for calendar year 1990 in the major industrial countries have been revised by an average of 3/4 of 1 percentage point, with the largest revision being a full 1 1/4 percentage point. Changes to the staff's estimates of potential are very small in comparison to these revisions to published historical data. Compared with projections of trend money velocity growth--which is another unobserved variable with important policy implications in many countries--the staff estimates of potential output growth would appear to be rock solid.

It is also worth noting that current estimates of potential output growth for 1995-98 are remarkably similar to the estimates published by the staff seven years ago in the August 1987 issue of the Staff Studies for the World Economic Outlook for the 1989-95 period; the difference is only 0.1 percentage point for Japan, France, and the United Kingdom, 0.2 percentage points for Italy and Canada, and 0.3 percentage points for the United States and Germany.

Mr. Smee said in his opening statement that, compared with the last world economic outlook exercise, Canada's medium-term potential growth is now lower because the natural rate is now estimated by the staff to be 9 percent compared with 8 percent previously. The 0.1 percentage point downward revision to the staff's estimate of potential growth for 1993-99 reflects a StatsCan revision for the 1990-93 national accounts data of the same magnitude. It is not true, however, that the staff's estimate of the natural rate in Canada has been revised up by a full percentage point; rather it has been revised up by 0.1 percentage point from 8.7 percent to 8.8 percent on average for the 1993-99 period.

Mr. Smee also made a number of comments in his opening statement to the effect that policy measures that have been taken in Canada to boost potential are not taken sufficiently into account in the staff's projections, and yesterday he suggested that this was also true for other countries--a point that Mr. Larsen also referred to. This point bears directly on the structural policy recommendations in the world economic outlook and I would therefore like to discuss this issue in some detail.

The structural reforms alluded to by Mr. Smee do show up in the projected natural rate for Canada, which declines from 9.3 percent in 1993 to 8.6 percent in 1999, and in the rate of growth of potential output, which increases from 2.6 percent in 1993 to 2.8 percent in 1999. The staff's projections of the rate of growth of potential output, incidentally, are in between those currently used by the Bank of Canada and the Department of Finance.

The staff considers these improvements in potential and reductions in the natural rate to be appropriate, given the extent of Canada's structural reforms. This assessment is based on the following considerations.

Although the U.S.-Canada Free Trade Agreement (FTA), the North American Free Trade Agreement (NAFTA), and the Uruguay Round will have positive effects on long-term growth, they are likely to be relatively small, as Canada's trade was already significantly liberalized, and the main benefits of the FTA and NAFTA are not in tariff reduction or removal of nontariff benefits, but in the establishment of dispute settlement mechanisms. While the value-added tax will have a positive effect in the long run, many have argued that it has hurt productivity in the short run, in part because the lack of harmonization with provincial taxes that has increased the complexity of tax filing, particularly for small businesses. The positive effect on potential growth of reducing the long-run rate of inflation by 2 3/4 percentage points is likely to be small, in the view of the staff. Although the staff does project a substantial decline in the structural budget over the medium term in Canada, the deficit nevertheless remains high and the credibility of the authorities' commitment to reducing the deficit remains to be fully established in financial markets. Finally, reform of the unemployment insurance system has been initiated, but the major overhaul of the system that has been promised by the Government has yet to take place.

Similar considerations would apply to other countries. For example, fiscal deficits remain high and the fundamental reforms that would be required to substantially lower structural unemployment in industrial countries have not, in general, been taken.

We agree with Mr. Dorrington about the need to avoid giving the impression of spurious precision when presenting estimates of potential output and of policy indicators such as structural budget deficits that are derived from these estimates. In the last world economic outlook, the estimates of structural unemployment were presented as the midpoint of a band to highlight the uncertainty attaching to the estimates, and we will incorporate caveats in the appropriate places in this world economic outlook. The staff's estimates of potential output, like all estimates, are surrounded by confidence intervals of uncertain size. This means that they must be taken with a grain of salt, and this is particularly true when they are estimated to be not too different from actual output.

On a related point, Mr. Kannan asked if the current high rate of unemployment in Europe is attributable to technical change that has resulted in capital being substituted for labor and, if so, what the policy implications would be of this type of unemployment. It is the staff's assessment that high rates of structural unemployment are ultimately the result of labor market policies and institutions that induce rigidities in real wages, hiring and firing practices, labor mobility, and training. It is increasingly the conventional wisdom that new technologies are changing the nature of job markets by increasing the returns to high-skilled workers and, correspondingly, by reducing the wages of low-skilled workers. This dynamic has contributed to the rise in income disparity in the United States, but in several European countries, where labor markets are less flexible, it may have been translated into higher rates of structural unemployment. As was argued in the previous world economic outlook, using labor market regulations to redistribute income is likely to be very costly in terms of losses in aggregate output and welfare. A better policy would be to increase labor market flexibility and thereby maximize potential output, and to use the tax and transfer system to redistribute income.

Mr. Glazkov offered insightful remarks on several of the key issues faced by economies in transition. He called for more attention to enterprise restructuring and conjectured that privatization and growth may not be closely related. The world economic outlook of last September discussed this issue at some length, pointing out that "privatization alone will not solve the underlying problems facing previously state-owned enterprises," and stressed the need for the development of commercial law and the improvement of corporate governance. It also emphasized the repercussions of poor enterprise performance on the typically weak and undercapitalized banking systems in transition economies--another topic Mr. Glazkov rightly highlighted.

Finally, Mr. Kafka and Mr. Glazkov raised some issues about the data presented in the statistical appendix. Mr. Kafka suggests the inclusion of data on depreciation in Table A43, which reports estimates of the sources and uses of world savings, and data on internal debt stocks in the statistical appendix. We agree in principle that it would be interesting to include this data. We are in the process of reconsidering the data requested of the desk officers in the world economic outlook submissions, and it may be feasible to add depreciation. On internal debt, there may be substantial definitional inconsistencies across countries, but we will take up this suggestion with our colleagues in other departments.

Mr. Glazkov asked about the data in Table A38 on external debt of developing countries to official creditors; in particular, he asked for details on the composition by major creditor country. The figures reported in Table A38 are for total external debt to official creditors (excluding debt to the Fund). We do not, however, have any estimates of developing country debt to individual official creditor countries, and this information is not collected in a systematic way by the Fund staff. The World Bank does, however, have country-specific data on debt owed to Russia. There are a number of potential problems with the Bank's estimates that the Bank highlights. First of all, the information the Bank receives is the representation of the country providing the data and they have no way of verifying its accuracy. Second, the content of the debt series differs across countries--for some countries it includes military debt, for others it does not.

Finally, not all of the countries with debt to Russia supply data to the World Bank.

Mr. Smee said that he had some lingering concerns about the baseline scenarios and the message they conveyed, which went beyond the concerns he had expressed with respect to Canada. At the time of the 1994 Article IV consultation with the United States (EBM/94/77, 8/31/94), for example, he had made the point that the reasons for the generally favorable projections for the U.S. economy and the financing of the current account deficit were not, on the basis of the baseline scenario, intuitively obvious: inflation to the end of the decade was projected to be higher than the average for all G-7 countries; the current account deficit was equivalent to about 2 1/2 percent of GDP, and would continue to require borrowing from abroad; the nominal exchange rate was depreciating year after year to maintain a constant real effect exchange rate; and interest rates would remain at the same level. On that basis, it was not clear to him how the United States would continue to attract funds from abroad and grow at potential, particularly in view of the projection for inflation of 3.4 percent toward the end of the decade.

The more general point, Mr. Smee continued, was that over the medium term there appeared to be little difference in performance between countries with different policy goals and success in achieving those goals. Despite widely varying circumstances and policies, the results in terms of growth seemed indistinguishable. In the case of Canada, for example, for all its success on inflation, there was little indication in the baseline of a reduction in the interest rate differential with the United States, as would be predicted by theory; indeed, theory would predict a sharp narrowing, or even a reversal, of the spread. The higher level of U.S. interest rates should have a positive effect on growth and potential growth, and thereby the structural deficit, in Canada. Therefore, he would encourage the staff in future to illustrate better the differences among countries with respect to performance, policy goals, and success in meeting those goals, and to explain more fully the nature of the differences. While the revisions to the baseline scenarios might appear small, they quickly became significant when accumulated over a number of years.

Mr. Abbott recalled that a staff paper prepared for the 1994 Article IV consultation with Japan showed that the Japanese savings rate, at about one third of GDP, would meet the so-called modified golden rule criteria. With the markdown in Japanese growth rates by 1 1/2 percentage points to 2 1/2 percent, and with an expected drop in the rate of growth of the labor force by 1 percentage point, he wondered whether the staff anticipated any impact on the optimal savings rate for the economy. The savings issue was related to the broader issue of the current account surplus, of course, which was expected to begin to decline in 1994. That expectation was somewhat difficult to reconcile with the fact that investment would rise only slowly, while the savings rate would remain high; indeed, a slower pace of investment seemed appropriate in view of the decline in the growth of the labor force.

The staff representative from the Research Department said that he had some sympathy for Mr. Smee's concerns. Part of the answer was to bear in mind the comparative advantage of the world economic outlook relative to the analyses presented for individual Article IV consultations. In country discussions, there was much more scope for the kind of work that Mr. Smee was alluding to; indeed, staff reports already incorporated alternative scenarios and detailed discussion of both short-term risks and medium-term issues. It would be difficult for the world economic outlook baseline to reflect adequately all aspects and differences among countries in one baseline projection. The world economic outlook was intended to complement the analyses and scenarios presented in Article IV consultations, and to examine interesting and relevant issues that cut across as many countries as possible and that were relevant in a global context and from a systemic perspective. From that perspective, it was easy to see how the baseline scenario might not satisfy all needs. The staff would be somewhat uncomfortable, however, with building into the baseline the possibility of cyclical movements several years into the future; not enough was known about the business cycle to be able to produce useful analyses beyond the near term. In that sense, it might be more useful to think of the baseline as reflecting average performance over a number of years, not necessarily implying steady growth from year to year.

Mr. Glazkov, referring to a question that he had raised at EBM/94/81, agreed that there were many difficulties with collecting data on external debt, but the detail he had asked for did not seem impossible to present. It was necessary to undertake such an effort and to maintain close cooperation among the Fund, the World Bank, the Russian authorities, and the office of the Executive Director for Russia. In that regard, the Executive Director had conveyed his full preparedness to cooperate and would like to see the same cooperative stance from the staff. On the data themselves, the issue went beyond the debt of developing countries to Russia; it was a more general question of the reliability of data on the indebtedness of developing countries.

The Chairman noted that the staff had demonstrated the full spirit of cooperation with the Russian authorities, and would continue to do so, in resolving the issues to which Mr. Glazkov had referred. In that regard, he welcomed the recent efforts of the Executive Director for Russia in facilitating that process.

The Economic Counsellor, commenting on the staff analysis of Japan's savings position at the time of the 1994 Article IV consultation, agreed that it might be useful to look again at that exercise. The so-called golden rule and modified golden rule criteria were appropriate to a closed-economy model, but the systemic issue of savings and the current account position in Japan clearly had to be viewed in an open-economy model.

On a more general point, he, too, had some sympathy for the concerns expressed by Mr. Smee, the Economic Counsellor remarked. In that regard, however, he would also note the point made at EBM/94/81 by Mr. Schoenberg to the effect that it would be a mistake to try to establish too close an immediate linkage between good policies and good outcomes. Such a relationship clearly held over the longer term; the experience across many countries over a long span of time gave confidence that maintaining reasonable price stability, fiscal balance, and openness to trade contributed to stronger growth performance.

By way of illustration, the Economic Counsellor continued, the seeds of the U.S. savings and loan problem, which would eventually cost the Government about $200 billion to resolve, had been sown in the early 1980s. At that time, financial institutions had tended to borrow short and to lend long, typically in the form of 30-year fixed rate mortgages. When short-term interest rates had been raised sharply to combat the inflation that had been allowed to accumulate in the economy, many financial institutions had generated enormous losses. Those losses, although hidden in the balance sheets of financial institutions, had continued to accumulate with the rate of interest until they had emerged relatively recently as a huge budgetary problem. One of the lessons of that episode was that it often took time to see the results of earlier mistakes; the same lesson could be applied with respect to the benefits of good policy decisions. A similar point had been made at the recent review of conditionality, where it had been suggested that the positive response to measures to improve growth performance in program countries was not likely to be apparent for several years.

Mr. Smee remarked that he was not expecting immediate benefits from prolonged periods of good performance, merely that the expected benefits would emerge in the foreseeable future.

The Economic Counsellor noted that, in the case of Canada, the negative effects of several years of poor performance on inflation and the budget deficit would continue to influence the evolution of the economy for some time. The effect of that performance was reflected, for example, in the decline in investment and, therefore, the estimates for potential growth. Thus, a medium-term horizon was the relevant context in which to view the linkages to which Mr. Smee had referred.

Turning to the discussion at EBM/94/81, the statements of Directors reflected unusually broad agreement with the staff analysis and policy recommendations on virtually the entire range of issues covered in the world economic outlook, the Economic Counsellor considered. It was important in discussing the issues of controversy and disagreement not to lose sight of that fundamental fact. Before making his general remarks on the discussion, he would make two preliminary remarks. First, he agreed that the published paper need not include text Box 11. Second, he was somewhat surprised at the request of many Directors for greater attention to exchange rate issues in surveillance discussions. There would be further opportunity to discuss that point in both a multilateral context and, as in the forthcoming Article IV consultation with Malaysia, individual country discussions.

With respect to the main issues in the world economic outlook, the Economic Counsellor commented, there was broad agreement with the revised forecast for growth for the industrial countries as a group, for the continuation of expansion in the United States and the United Kingdom, and for the continued generally bright prospects, despite some difficult cases, for the developing countries as a group. On Japan, he was not at all concerned that the staff's forecast for growth in 1995 was a little above the consensus at present. The forecast for 1994 might need to be revised upward somewhat as the staff received more data; as always, there were uncertainties in making forecasts.

Several Directors had asked about the relationship between the staff's forecasts and certain policy issues, the Economic Counsellor recalled. A similar point had been made by Mr. Evans, the former Executive Director for Australia, at the spring 1993 discussion on the world economic outlook. At that discussion, which had centered on the substantial downward revisions to the staff's forecasts in the face of a recession that had not been foreseen by the staff, Mr. Evans had asked the staff whether its policy advice would have been any different if its forecasts had been more accurate. That was an important question to reflect on occasionally; having reached a turning point in the current business cycle, the present discussion afforded a good opportunity for such a reflection.

For the United States, the Economic Counsellor continued, economic growth had turned out to be stronger than had been forecast one year earlier. At that time, the staff had been forecasting 2.6 percent growth for 1994, compared with a current forecast for the year about 1 percentage point higher. In terms of policy advice, the revision to the growth forecast made no difference. The basic argument remained that there needed to be further fiscal consolidation. The fact that the recovery was a little stronger than expected, if anything, strengthened the case for taking some of the burden off monetary policy by adopting the necessary fiscal measures while the economy was expanding rapidly.

With respect to U.S. monetary policy, the staff had long noted that there would be a need to firm monetary conditions as margins of slack diminished, the Economic Counsellor observed. It was difficult to prescribe exactly when that process should be started and how aggressively it should be pursued, and no attempt had been made to do so. By the time of the mid-December 1993 WEMD session, with the strong employment report in November 1993 and other evidence that fourth quarter growth of the U.S. economy would be much stronger than expected, the staff had sent a clear message that, in its judgment, the time had come to begin the process of tightening monetary conditions by moving toward neutrality. As the evidence emerged that growth in the first half of 1994 had continued to be stronger than expected, the staff had continued to indicate, including at the mid-July 1994 WEMD session, that some further tightening had been appropriate at that time. At that meeting, he had referred to a possible federal funds rate of about 5 percent and a discount rate of up to 4 percent; those rates had in fact moved somewhat closer to the figures he had mentioned with the latest move by the Federal Reserve. In his view, that was how the surveillance process on those issues should operate; increasingly, there was an overlap between the WEMD sessions and the world economic outlook exercise.

The recovery in Europe had clearly started somewhat earlier and had been more vigorous than anticipated one year--or even six months--earlier, the Economic Counsellor said. One year earlier, he had noted the upside risk that recovery would start earlier and be stronger than anticipated by the staff; if that were to happen, he had indicated, the margins of slack had been sufficiently large to avoid any immediate problems. In terms of policy advice, the staff's advice on the general need for fiscal consolidation and the lack of room for fiscal stimulus, beyond use of automatic stabilizers, had been entirely appropriate, even if growth had turned out to be a little stronger. With respect to monetary policy in European countries, the story was much the same as for the United States. Adjustment of key interest rates needed to be made in the light of current information about ongoing developments in the economy. The staff had been indicating since late 1992 that gradual, persistent, and cumulatively substantial reductions of policy-determined interest rates would be appropriate; in fact, interest rates had moved in precisely that direction.

The strength of the recovery in Europe testified to some extent to the relevance and correctness of the staff's policy advice, the Economic Counsellor commented. Moreover, the fact that the recovery was a little stronger than anticipated suggested that short-term interest rates did indeed matter in Europe. Part of the reason for the relatively strong impact of short-term interest rates was that recovery in Europe was a mutually reinforcing process; lower interest rates in Germany, for example, benefited the German economy not only through the direct effect on domestic demand in Germany, but also by increasing demand elsewhere in Europe, contributing to the recovery of confidence and so forth. Thus, the staff's policy advice had essentially been right.

By June 1994, the Economic Counsellor continued, it had been apparent to the staff, as it had also to the Bundesbank, that the slope of the yield curve for German interest rates had become positive. Policy-determined interest rates had been reduced by that stage to a little over 5 percent; the repurchase rate had since come down another 25 or 30 basis points. In light of the recovery, the positively sloped yield curve, and the rapid growth of monetary aggregates, it had seemed sensible to suggest that the time had come to hold the main policy-determined interest rates steady for a time. If inflation continued to come down and money was reduced to more reasonable levels, a further reduction in the discount rate might be appropriate later in 1994 or early in 1995, but there was no need to prejudge that issue at the present time.

Mr. Schoenberg said that he disagreed with the Economic Counsellor on the possible need for a reduction in interest rates in Germany. Official growth figures for Germany, released only the previous day, showed that the economy had grown by 2.8 percent in the first half of 1994. The April 1994

World Economic Outlook, by contrast, had projected German growth of 0.9 percent in 1994, against 2.25 percent in the current exercise. The new figures indicated that even the current staff projection might be too low. Moreover, it was not the case that the Bundesbank had done precisely what the staff had recommended; in fact, there had been a strong reaction to the decision of the Bundesbank to pause in further reducing interest rates. Given the time lags normally associated with monetary policy, it appeared that the Bundesbank had had some reason to be cautious in its interest rate reductions. If forced to react immediately to each development in the economy, it would be difficult to see how central banks could implement effectively a medium-term-oriented monetary policy.

The Economic Counsellor replied that he did not see the same difficulty in terms of the medium-term orientation of monetary policy. Monetary policy was implemented on essentially a week-to-week basis. In the case of the Bundesbank, there had been a relatively continuous adjustment of policy-determined interest rates. The Bundesbank Council was, appropriately, making judgments in the light of a good deal of incoming information about how monetary policy should be adjusted. On the arguments in favor of a temporary pause in reducing policy-determined interest rates, the staff view was that the conditions that had prevailed one year earlier--when short-term interest rates had been quite high in real terms, economic activity had been falling, and the yield curve had been negative--had changed substantially. The economy was currently recovering briskly; export growth was an important, but not exclusive element of that recovery. The yield curve was positively sloped. Monetary aggregates, such as German M3, had stagnated for the past four months, but the earlier monetary expansion suggested that there was enough liquidity in the economy, at least in the very near term.

On balance, the Economic Counsellor considered, the relevant indicators suggested that the time had come for a pause in the process of interest rate reductions. Indeed, it was conceivable that a floor to that process had been reached, but much would depend on the conditions that emerged over the course of coming months. That message appeared to be consistent with recent statements by the President and senior management of the Bundesbank. If the recovery had been nonexistent or very sluggish at the present stage, the judgment of the staff on the issue of the further movement of interest rates, and that of the Bundesbank, would have been somewhat different. The Bundesbank looked at the facts as they emerged and adjusted its policy in the light of them.

Mr. Schoenberg said that he could agree with the remarks of the Economic Counsellor. Both the staff and the Bundesbank had underestimated developments in the German economy. It would certainly not be the case, moreover, that the staff's advice would not have been different in the event that it had known in advance of the extent of the recovery. Indeed, the Bundesbank's policy would probably have been somewhat different under those circumstances. The conclusion he would draw from that aspect of the present discussion was that the Fund should be more cautious in combining policy advice with very short-term economic growth prospects, because they could be misleading.

The Economic Counsellor agreed that the staff's advice would probably have been different under the circumstances described by Mr. Schoenberg. The process of adjustment of interest rates was an ongoing one: the current view of the staff, as well as of the Bundesbank, was that it would be appropriate to pause for a while in reducing interest rates; depending on developments in the economy, the staff's advice might have been different. Of course, there were important nuances to consider, and reasonable people could be expected to differ within a narrow range on judgments of monetary policy.

He disagreed with Mr. Schoenberg, however, on the need for the Fund to make those kinds of judgments, the Economic Counsellor said. In the case of the United States, where the direction of monetary policy was currently different than in Germany, it was equally important to diagnose not only the general case for raising policy-determined interest rates as the expansion proceeded and margins of slack became smaller, but also more specifically the timing and pace of that process. There appeared to be no way to make those judgments other than looking at a variety of relevant economic indicators. Indeed, if surveillance was to be meaningful, those judgments needed to be made; and if surveillance was to be credible, judgments would need to be made in both directions, and, of course, in cases where the direction of movement was not likely to be well determined until clearer evidence emerged.

With respect to the transition economies, the issues that Mr. Glazkov had raised had indeed been covered in the present and past world economic outlook exercises, the Economic Counsellor noted. They deserved and were receiving more detailed attention on a continuing basis. The world economic outlook, however, might not be the most appropriate context in which to bring a more detailed consideration of those issues to the Board. There would, of course, be opportunities in Article IV or general policy discussions to examine those issues in more detail.

Mr. Glazkov remarked that he remained convinced that the coverage of transition economies in the world economic outlook needed to be improved. He recognized the difficulty of incorporating new issues into the staff papers for the world economic outlook exercise, but he could not accept that the issues to which he had referred were not suitable for inclusion. He was not suggesting that the coverage of transition economies be extended, merely that the analysis be more forward looking.

The Chairman said that the point made by Mr. Glazkov was well taken, and could be taken up at the time of the next discussion on the Board's work program.

The Chairman made the following summing up:

The recovery and projected further strengthening of world economic activity have provided a welcome positive theme in our discussion of global economic developments. Directors shared the view that the current cyclical juncture provides a welcome opportunity that we should not fail to use for more forward-looking consideration of a range of economic policy issues and actions to ensure that the expansion is used wisely. They agreed that adoption of appropriate policies in a medium-term framework should help to reduce the risk of a recurrence of the kinds of economic and financial difficulties experienced recently.

The fiftieth anniversary of the Bretton Woods Conference makes this an appropriate occasion to reflect on the performance of the world economy over the past five decades. Directors cited in particular the contribution to global prosperity of international policy cooperation, which has been the hallmark of the Bretton Woods achievement. Speakers noted that trade has grown significantly faster than output in almost all regions of the world. The benefits, in terms of increased opportunity for specialization, greater incentives to invest, and more rapid technology transfer, have been substantial and widespread. Against the background of this favorable retrospective, however, several Directors emphasized that many industrial countries have experienced a serious worsening of labor market conditions, with rates of unemployment approaching levels not seen since the 1930s. They also stressed that not all regions have kept pace with the general improvement in living standards, and in particular that per capita real GDP is lower now than it was a decade or more ago in many developing countries.

Directors were positive about longer-run trends in the world economy, because of the substantial improvements in economic policy and performance in a growing number of developing countries, the improvements in economic management now under way in the countries in transition, the considerable progress toward price stability in many countries, and the growing recognition in industrial countries of the need to improve the functioning of labor markets and to strengthen the financial position of the public sector. In this context, they stressed that the challenges ahead call for sustained commitment to the cooperative strategy set out in the Interim Committee's Declaration of April 1993. They emphasized that global economic performance will be enhanced by the entry into force of the Uruguay Round trade agreements, by the deepening of regional integration efforts in Europe and in other parts of the world, and by the welcome trend toward currency convertibility and liberalization of capital movements. All of these developments promise to extend the dynamic relationship between trade and growth that has characterized the past 50 years.

New trade opportunities will stimulate economic growth directly, increased international competition will enhance efficiency and help to keep inflationary forces at bay, and the creation of the World Trade Organization will foster a more predictable, rules-based global trading environment. Directors urged the countries concerned to ratify the Uruguay Round agreements without delay.

Directors agreed with the staff that recoveries were finally under way in France, Germany, and other countries in continental Europe, that clearer signs of a turnaround had appeared in Japan, and that the expansion in the United States had continued at a strong pace. In Canada, recent indicators had been favorable, with strong growth through the second quarter, consumer prices essentially stable, and long-term interest rates declining from their recent peaks. The expansion in the United Kingdom was also proceeding at a robust pace, with little immediate risk of rising inflation.

Overall, Directors agreed with the revisions to the staff's growth projections. After the difficult last few years, it was a welcome change to see upward revisions to the growth estimates for the industrial countries. Some Directors recalled the tendency of forecasters to underpredict the initial strength of recoveries, but most regarded the upside potential and the downside risks to the projections as reasonably balanced. Most speakers reiterated their long-standing concern about the poor functioning of labor markets in Europe and the danger that the recent increase in cyclical unemployment might become structural and, hence, might persist. They underscored the urgent need for fundamental and far-reaching labor market reforms as discussed in depth in the May 1994 World Economic Outlook.

Many Directors stressed that a clearly warranted feeling of optimism about the period ahead should not be permitted to lead to complacency over the medium-term outlook. Many policy challenges remained to be tackled to ensure a durable expansion, to avoid a repetition of past policy mistakes, and to take full account of important policy lessons from the 1980s. In this context, several speakers expressed concern about the sharp increases in long-term bond yields in the first half of the year, which were viewed as a possible sign of underlying pressures in capital markets. Increased demand for funds in more strongly expanding industrial economies, combined with the ongoing need for investment capital in transition economies and in developing countries, pointed to a high level of private sector demand for capital in coming years. With private saving rates low or declining in many large countries, and with the considerable absorption of savings by the public sector, there was a risk of continued and perhaps increasing pressure on world real interest rates, which could constrain future growth.

Speakers were therefore unanimous in their call for renewed commitments to containing and reducing fiscal deficits, as stressed in April 1993 by the Interim Committee. This was viewed as an essential condition for alleviating pressures on long-term interest rates and to permit satisfactory rates of economic growth and job creation in the future. Efforts that go beyond the effects of automatic stabilizers will be needed to place fiscal policy on a sound medium-term footing in virtually all countries. Directors underscored the need for decisive steps to improve the fiscal outlook in Italy and Sweden. Other countries should also take advantage of the expansions now under way to substantially reduce the public sector's absorption of private saving.

With respect to monetary policy, the discussion focused on the risks that lie ahead as more countries enter the expansionary phase of the business cycle. Safeguarding the progress made toward price stability in many countries was emphasized by all Directors as a critical condition for a durable expansion. Speakers generally considered the present stance of monetary policy to be appropriate in most countries. Margins of slack in Europe are still considerable, notwithstanding uncertainty about the precise magnitude of the gaps between actual and potential output, and the possibility of an early increase in inflation appears small. At the same time, the forces of recovery are beginning to be domestically generated and mutually reinforcing. There was general agreement that the actions undertaken in the United States to shift monetary policy away from its earlier expansionary stance had been appropriate and timely. The demonstrated willingness of the Federal Reserve Board to act should provide reassurance to markets in the period ahead. With respect to Japan, most Directors considered that it was best at this stage to wait and see how the expansion develops before taking action to adjust monetary policy. A few speakers felt that there may be scope for a further modest easing of monetary conditions--this view was not shared by others--consistent with both domestic and external considerations.

In the area of foreign exchange markets, Directors expressed some concern about recent movements in the exchange rate between the U.S. dollar and the Japanese yen, especially in view of the risk that the strength of the yen might delay the resumption of stronger growth in Japan. More generally, Directors emphasized the need for more effective Fund surveillance to help to foster conditions that would be conducive to a greater stability of exchange rate relationships.

In addition to their comments about labor market reforms and the Uruguay Round, Executive Directors stressed that structural reform on a broad front in all industrial countries would help to underpin medium-term growth prospects. In many countries, further deregulation of labor, product, and capital markets would enhance economic dynamism and efficiency. Some Directors pointed out that changes to tax systems could enhance economic efficiency by reducing distortions, and could increase private sector savings, permitting stronger investment and productivity growth.

Turning to the developing world, Directors were encouraged by the continued strong growth performance of many countries. However, the strong aggregate performance masked considerable diversity, a point emphasized several times, and they expressed concern that growth was weak, and standards of living had continued to stagnate or decline, in many countries. Directors noted that divergences in economic performance have mainly reflected the varying degrees of success in implementing appropriate macroeconomic stabilization policies and structural reforms as well as differences in external conditions faced by individual countries. In sub-Saharan Africa, despite indications of a brightening economic outlook in several countries, economic conditions overall remain particularly unsatisfactory and much remains to be done to reverse, on a durable basis, the recent pattern of declining living standards. Critical to this endeavor would be increasing domestic saving, reducing inflation in some countries, enlarging the scope for market mechanisms, and improving governance. While speakers did not single out the latter point in their interventions, several Directors have subsequently stressed the importance of good governance, both in a sub-Saharan African context and more generally. Directors also emphasized that the beneficial effects on growth associated with the recent adjustment of the CFA franc, and other currencies, would depend upon a steadfast implementation of the accompanying stabilization policies and structural reforms in the countries concerned.

In the Middle East, inflation has remained relatively high and growth has slowed somewhat as the temporary boost from reconstruction in some countries during 1992-93 has dissipated. Directors welcomed the prospect of a lasting peace settlement in the region, as this would offer the opportunity to revitalize adjustment and reform efforts, reduce defense expenditures, and address important issues in the areas of infrastructure and regional cooperation. Directors were particularly encouraged by the marked improvement in economic performance of many developing countries in the Western Hemisphere in recent years and the continuing impressive performance of many Asian countries.

Directors welcomed the substantial rise in private capital flows to many developing countries since the late 1980s, while noting that this development required careful monitoring, given the tenuous nature of some types of capital flows and the potential for adverse domestic side effects. The recent surge in capital inflows had helped some developing countries to sustain relatively rapid growth during a period of weakness in the industrial countries. Moreover, a substantial portion of total flows is now in the form of private, non-debt-creating capital. Directors were particularly encouraged by the rising share of foreign direct investment, which also brought a transfer of technology and helped to increase exports. Countries in Asia and in the Western Hemisphere have been the main recipients of the recent capital flows, owing both to the size of their markets and to their record of progress toward macroeconomic stabilization. It was noted that the moderation of capital flows in the first half of 1994 seems mainly to reflect the strengthening of the recovery in the industrial countries and the associated firming of interest rates worldwide.

A concern of a number of speakers, however, was that in a few countries, the rise in capital inflows appeared to have been driven by the general enthusiasm for emerging financial markets, which might put these countries at risk to sudden changes in market sentiment. Directors also expressed concern about the sustainability of capital flows to some countries where the flows are related to high short-term interest rates due to an inappropriate mix of lax fiscal policy and tight monetary policy.

Directors noted that where capital inflows are primarily the result of policy changes, such as structural reform and fiscal adjustment, a real exchange rate appreciation is more likely to be the appropriate equilibrating response to improvements in productivity and profitability. In contrast, where capital inflows are caused by restrictive credit policies that raise short-term interest rates and are not supported by sustainable fiscal policies, an exchange rate appreciation may be more disruptive. Moreover, such countries may be more vulnerable to sudden reversals of capital flows.

Many developing countries have recently attempted to slow the inflow of capital by resorting to a variety of mechanisms, such as ceilings on foreign borrowing, minimum reserve requirements on foreign loans, and interest rate equalization taxes. A few Directors noted that capital controls may be helpful in preventing capital flows from destabilizing the domestic economy, particularly during the early stages of a structural reform program, and may also help countries to limit the potential complications for macroeconomic management that can arise from sudden reversals of capital flows. Other speakers cautioned, however, that capital controls should not be viewed as a substitute for correcting policy imbalances and that restrictions on capital flows are unlikely to be effective over the longer run, and may distort investment decisions.

In discussing the countries in transition, Directors observed that those countries that had gone furthest in implementing financial adjustment and liberalization--including Albania, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Mongolia, Poland, the Slovak Republic, and Slovenia--had demonstrated that macroeconomic stabilization and structural reforms were prerequisites for achieving sustained growth and low inflation. In contrast, in Russia and many of the other transition countries, output had continued to decline precipitously. A number of these countries had made some progress toward stabilization and reforms, but most had yet to reduce government budget deficits sufficiently or to bring inflation under control. Policy slippages had exacerbated the decline in output associated with economic restructuring, jeopardized the credibility of the reform efforts, and created a more uncertain investment climate. Containing government budget deficits was emphasized as an important element in reducing inflationary pressures.

Directors recognized that budget deficits had been difficult to keep within sustainable levels in all but a few of the countries in transition, and that in all countries the transformation process had profound implications for government revenues and expenditures. It is apparent that the resulting budget deficits were to some extent a by-product of the transformation process, which underscored the need to give high priority to reforming government fiscal systems. Speakers attributed the persistence of budget deficits mainly to the sharp decrease in tax revenues resulting from the collapse in output and the inadequacy of tax systems, as well as to expenditure pressures related to the restructuring of state enterprises, the need to strengthen social safety nets, and the costs of support for aging populations.

Increases in unemployment were acknowledged to be largely unavoidable in the transformation to a market economy, which required large-scale enterprise restructuring and the reallocation of capital and labor. To protect the unemployed during the transition, Directors emphasized the need to put in place adequate social safety nets that are well-targeted and accompanied by cuts in subsidies and unproductive expenditures. In addition, new labor market institutions that promote flexibility and improve employment prospects should be established. The point was also made that in parallel with efforts to put in place appropriate social safety nets, institutional efforts to establish sustainable social security systems were also required.

Finally, Directors expressed concern that while the problem of arrears among enterprises had receded in several of the economies in transition, new problems had persisted or had even risen further in a number of cases. Directors welcomed the increasing recognition by policymakers of the inflationary dangers of any bail-out measures, and emphasized that continued progress with stabilization and structural reforms would help to reduce the scale and scope of interenterprise arrears.

The Chairman noted that the staff would carefully edit the text of the world economic outlook to ensure that any material that could bring about any undesirable market reaction was removed, and that the analysis was presented in a manner that took into proper account the concerns of national authorities. Directors were invited to provide comments to the staff until close of business on Monday, September 12.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/94/81 (9/8/94) and EBM/94/82 (9/9/94).

4. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 94/40 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by Assistants to Executive Directors as set forth in EBAM/94/150 (9/7/94) is approved.

APPROVAL: November 14, 1995

LEO VAN HOUTVEN
Secretary

To: Mr. Van Houtven September 1, 1994

From: Marc-Antoine Autheman

Subject: Pakistan

F-94/406

I read with great interest the very informative report from the staff (EBS/94/159) on the mid-term review of the first annual arrangement under the ESAF of Pakistan.

I understand from this report that all end-March and end-June performance criteria and benchmarks were and will be met.

We had a very comprehensive discussion on Pakistan's economic situation and reform program last February. Accordingly, I would suggest, in view of the information guidelines agreed upon during our last work program discussion (cf. your Buff 94/56), that the Board discussion on the mid-term review of Pakistan's program scheduled for September 9, 1994 be canceled except, naturally, if one other Executive Director is of the view that a Board discussion prior to the completion of the review is necessary.

cc: Mr. Mirakhor
Executive Directors
Mr. Chabrier
Mr. El-Erian