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May 1, 1997
Approval: 5/8/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/88

10:00 a.m., September 15, 1995

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Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, Acting Chairman
P. R. Narvekar, Deputy Managing Director
A. D. Ouattara, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
M.-A. Autheman	A. Fayolle
	D. Desruelle, Temporary
	L. Fontaine, Temporary
	E. Srejber
	V. J. Fernández
	J. Guzmán-Calafell, Temporary
	A. Ruocco, Temporary
I. Clark	G. F. Murphy
	D. Z. Guti
H. Evans	J. Shields
K. P. Geethakrishnan	W. Hettiarachchi
	R. Kannan, Temporary
J. E. Ismael	L. M. Cheong
	D. Gotz-Kozierkiewicz
	U. Issaev, Temporary
A. Kafka	J. John, Temporary
W. Kiekens	J. Prader
	J. Jonás, Temporary
	J. Hamilius, Temporary
Y.-M. T. Koissy	A. Barro Chambrier
G. Lanciotti	N. Coumbis
K. Lissakers	B. S. Newman
	J. M. Abbott, Temporary
	M. W. Ryan, Temporary
H. Mesaki	Y. Tahara, Temporary
	S. Fukushima, Temporary
A. Mirakhor	
	A. G. Zoccali
	J. Leiva, Temporary
S. Schoenberg	
A. S. Shaalan	Y. Y. Mohammed
D. V. Tulin	E. Kouprianova, Temporary
	J.-H. Kang
J. de Beaufort Wijnholds	O. Havrylyshyn
Zhang M.	Wei B.

L. Van Houtven, Secretary and Counsellor
T. Ranaweera, Assistant
R. Bradshaw, Assistant

Also Present

IBRD: R. P. Brigish and N. Kamel, International Economic Department; K. E. Jay, Resource Mobilization Department; W. A. McCleary, East Asia and Pacific Regional Office. African Department: C. Brachet, Deputy Director; G. E. Gondwe, Deputy Director; J. A. Clément, G. G. Johnson, M. Katz. Central Asia Department: H. Neiss, Director; J. R. Dodsworth, R. P. Hagemann, M. G. Kuhn, W. Peng, K. Srinivasan. European I Department: M. Russo, Director; M. C. Deppler, Deputy Director; J. R. Franks, D. L. Gleizer, F. Scacciavillani. European II Department: E. Brau, Deputy Director; A. J. Richards. External Relations Department: S. J. Anjaria, Director; F. Baker, P.-F. Falcone, G. Hacche, C. Liuksila. Fiscal Affairs Department: E. de Callatay, L. Schuknecht. IMF Institute: H. Cortes, A. Ouanes. Legal Department: R. H. Munzberg, Deputy General Counsel; R. Baban, J. L. Hagan. Middle Eastern Department: P. Chabrier, Director; M. A. El-Erian, Deputy Director; P. Alonso-Gamo, S. Eken, M. E. Hansen, E. Maciejewski, C. J. McDermott. Policy Development and Review Department: J. T. Boorman, Director; M. Allen, Deputy Director; D. N. Lachman, Deputy Director; T. Leddy, Deputy Director; D. J. Andrews, G.C.Anayaiotos, A. R. Boote, R. M. Brooks, N. Calika, B. V. Christensen, B. Dabrowska, C. Daseking, S. V. Dunaway, O. J. Evans, J. Fernandez-Ansola, M. Fisher, N. L. Happe, C. J. Jarvis, R. F. Krieger, R. H. Nord, D. C. Ross, K. Thugge. Research Department: M. Mussa, Economic Counsellor and Director. Secretary's Department: A. Mountford, W. S. Tseng. Treasurer's Department: J. C. Corr, C. A. Hatch, M. A. Wattleworth. Western Hemisphere Department: E. S. Kreis. Office of the Managing Director: K. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant; J. Quick, Personal Assistant Designate. Advisors to Executive Directors: B. Andersen, P. Cailleteau, T. K. Gaspard, J. Justinaino, Y . Margoninsky, M. F. Melhem, S. N'guiamba, J.-C. Obame, M. Petrie, A. V. Vernikov, R. von Kleist. Assistants to Executive Directors: T. Berrihun, R. D. Bessone Basto, M. A. Brettschneider, A. G. Cathcart, D. Daco, J. Dagustun, J. C. Estrella, D. Giga, M. Giulimondi, C. M. Gonzalez, A. Guennewich, O. A. Himani, G. H. Huisman, T. Isataev, W. C. Keller, A. M. Koulizade, T.-M. Kudiwu, G. A. Kyriacou, N. L. Laframboise, J. Mafararikwa, M.-H. Mahdavian, J. Pesola, H. Petana, G. P. Ramdas, S. Rouai, K. Sakr, V. Trivedi, M. Yiu, Zubir bin Abdullah.

1. DEVELOPING COUNTRIES - FINANCING AND DEBT SITUATION

The Executive Directors considered staff papers on official financing for developing countries and their debt situation (SM/95/224, 9/1/95), and on private market financing for developing countries and their debt situation (EBS/95/126, 8/1/95). They also had before them a background paper on official financing for developing countries and their debt situation (SM/95/228, 9/8/95) and background material on private market financing for developing countries (SM/95/197, 8/14/95; and Cor. 1, 8/18/95).

Mr. Clark made the following statement:

To begin, let me thank the staff for a thorough set of papers which further illuminate the financing and debt situation facing developing countries. In this regard, I appreciate the continuing efforts of the staff to respond to the interests of members on the matter. Since the issues for discussion in both papers are fairly straightforward and sensible, I will only comment on those with which I do not completely agree, or on which I draw different conclusions than the staff.

In paragraph three of the Issues for Discussion, I was interested in the staff's suggestion that the Fund support private debt reduction for low-income countries with resources from a small SBA (in conjunction with an ESAF arrangement). This is not inconsistent with the discussion last week about blending ESAF and GRA resources for a certain class of borrower; however, a case-by-case approach will be necessary to ensure that such support is warranted. Great care will have to be taken to ensure that the overall debt relief achieved justifies the cost and that we are not exacerbating the debt-service problem of low-income countries by providing more non-concessional financing. In this sense, the same assessment of balance of payments prospects and debt-service capacities will be crucial.

The staff's hypothetical analysis uses agreed rules (Paris Club Naples terms) to look at how the debt position of low-income countries would evolve after stock-of-debt reduction. I have two comments on the staff's analysis and conclusions regarding the debt sustainability of heavily indebted low-income countries.

First, the analysis makes the following rather optimistic assumptions: other bilateral and private debts receive comparable debt reduction treatment; the countries in question receive continued highly concessional bilateral aid flows; they persevere with strong adjustment programs and hence continue to receive new concessional inflows from multilaterals; and, they achieve export growth of 8-15 percent and build up foreign reserves substantially.

Looking at export growth, the staff has used forecasts from individual PFPs which are considerably more optimistic than those used in the stylized exercise earlier this year. It is worth noting that three-year structural adjustment programs embodied in PFPs are projections based on assumed positive outcomes of successive annual arrangements. Over time, programs usually end up being revised regularly. In addition, the dynamic effects of debt overhang on investment and growth have not been incorporated into the forecasts. This is noteworthy for those four countries (Bolivia, Guyana, Honduras, and Uganda) included in the study of 14 which the staff judges as having good exit prospects despite debt-service ratios over 20 percent for the next seven years (until 2002).

Despite the generous assumptions underlying the medium-term analysis, the staff concludes that, "for a minority of currently eligible countries, existing mechanisms would not appear to provide good prospects for a durable exit from the rescheduling process." This implies that the problem is more daunting than some of our recent Executive Board discussions would imply.

Second, the staff analysis did not deal with all the problem countries. Of the 14 countries examined, the staff has concluded that Mozambique, Nicaragua, Zambia, and possibly Sierra Leone have little prospect of achieving sustainability. However, as the staff noted in the report, several others with high debt levels were omitted from the study of 14 because they were not suitable for comparison. These include 10 countries which are not yet eligible for Naples terms or have not achieved a solid policy track record: Angola, Burundi, Cameroon, Guinea-Bissau, Madagascar, Rwanda, São Tomé and Principe, including three in arrears--Somalia, Sudan, and Zaïre.

Consequently, there are at least 10 other countries outside of the staff's study of 14 for which sustainability is definitely questionable. This expands the list of problem cases to at least 14, close to the findings of the work carried out by the staff early this year. While staff papers have been very useful, I do not think we can ignore these other members.

In conclusion, there are a small but significant group of countries with debt burdens which, however one looks at it, will impede their growth prospects. From this I can make two suggestions, both of which I raised earlier this week in the Board: To ensure continued access to ESAF for all low-income countries making worthy adjustment efforts, we must continue to explore ways and means of financing an interim ESAF. The Fund must work with other multilateral financial institutions and with other creditors to develop a comprehensive solution to the debt problem of low-income countries.

Mr. Shaalan made the following statement:

The first set of papers before us on private financing raises some important issues related to developing countries' commercial debt management, their access to private market financing, and the sustainability of their external indebtedness.

It is encouraging that substantial progress has been made in the resolution of bank debt problems, and that increased flexibility has been effective in dealing with such problems on a case-by-case basis. Countries that remain heavily indebted to commercial bank creditors are advised to take advantage of the relatively favorable current market conditions. There are, nonetheless, some low-income country cases where straight debt buy-backs continue to be prohibitively expensive and where stock-of-debt reduction operations depend on the availability of concessional resources from multilateral institutions and bilateral donors. I would urge the staff to deploy strong efforts in this regard by helping to mobilize the necessary resources for those countries and, where possible, by providing Fund financial support in the form of stand-by augmentations in conjunction with ESAF arrangements.

The staff's analysis of the Mexican crisis spill-over shows that the increasing share of institutional investors' participation has magnified the effects of the crisis in other developing country markets. The similarity in the timing and behavior of institutional investors in general, coupled with their tendency to identify developing country securities as a distinct asset class, was a significant factor in the selling off of securities across a broad range of countries regardless of their fundamental economic situation. It is unfortunate that the same kind of behavior could be expected in case a similar crisis erupts in the future. More encouragingly, however, the experience of the Asian and Latin American markets in the aftermath of the Mexican crisis shows that, in the final analysis, selling pressures quickly wane and do not persist where economic fundamentals do not justify a sell-off. This underscores the importance of the consistent implementation of sound macroeconomic policies in ensuring continued access to foreign capital on reasonable terms.

Another important issue raised by the Mexican crisis, and to some extent by the recent appreciation of the yen, concerns the appropriateness of external debt management practices. In addition to the obvious dangers of short-term borrowing, the staff is right to underscore the importance of a careful assessment of the foreign exchange risks when countries borrow in foreign currencies carrying low interest rates. Adequate hedging of foreign exchange risk, either indirectly by keeping the currency composition of foreign borrowing in line with the composition of exchange earnings or explicitly through the use of appropriate financial market instruments, is essential. The Fund could help build expertise in this area through the provision of technical assistance.

The Mexican crisis illustrated how the difficulties faced by the authorities in honoring their obligations could negatively affect the private sector's ability to service its debts, thereby aggravating the country's financial crisis. The staff also points to the implication for macroeconomic policies of growing foreign borrowing by the nongovernment sector. Problems that originate in the private sector, whether of a financial or non-financial character, could quickly lead to difficult challenges to macroeconomic policies. A careful monitoring by the government of all debt flows is, therefore, extremely important. I thus found well taken the staff's cautionary note that "as the capital account is liberalized, it is important that the ability of non-government entities to access foreign markets does not outstrip the ability of the government to monitor these activities, particularly in countries in the process of stabilizing their economies."

On official financing, the papers address the central issue of External Debt Sustainability (EDS) of 41 heavily indebted poor countries through stock-of-debt operations under Naples terms. Despite the caveats that are usually associated with the concept of sustainability, the staff has nonetheless come up with a workable set of indicators, listed in Box 8 of the main paper, which is centered on the capacity of future exports to service debt obligations. I would suggest, in this regard, to add to this set the indicator I/GDP (the share of gross fixed investment in GDP) since this ratio provides a good proxy for a country's capacity to generate real export growth, which constitutes the major element of a country's Executive Directors.

The staff's findings indicate that, for most low-income countries, stock-of-debt operations offer good prospects for Executive DirectorS, provided that comparable Naples terms are offered by other official bilateral and private creditors, that donors continue to provide concessional assistance, and that strong adjustment and structural reform policies are implemented. They also indicate that for most heavily indebted countries substantially more concessional assistance would be needed. I also find especially striking the fragility of Executive Directors, as illustrated by its sensitivity to small deteriorations of only 1 percent in interest rates or in export growth. If one major conclusion is to be drawn from this analysis, it is that the staff findings confirm that, to achieve Executive Director or indeed sustainable growth in general, there is no close substitute to strong adjustment and structural reform policies.

Ms. Lissakers made the following statement:

The staff papers on private and official financing flows for developing countries and their debt situations make an important contribution to our on-going discussion of debt dynamics, particularly in the poorest, most heavily-indebted countries. Looking at trends in both the private and official arenas provides the necessary perspective on the debt issue as a whole, and is the right way to go about our analysis. The key lesson to be drawn is that the external obligations of the poorest countries need to be considered within a comprehensive approach. What we see is that progress is being made in settling commercial bank claims, although some problem cases remain, and that bilateral official creditors are taking concrete action to address unsustainable debt burdens of borrowing countries through Naples terms. The missing piece is how to come to terms with the multilateral portion of their debt burden.

The staff acknowledges that their analysis of debt sustainability is still preliminary and incomplete. We concur that there are a number of areas where more work is needed in order to make specific policy recommendations on exactly how to address these issues. What is clear to us, however, is that, even under the papers' conservative assumptions, there is a significant multilateral debt problem for a number of heavily indebted poor countries--perhaps not the majority, but a significant number of countries--that needs to be addressed by the international financial community, including the Fund.

There are a number of improvements in this set of papers that build on our past discussions. As a first example, the recognition that an increased focus is needed on the analysis of debt sustainability in staff reports of the heavily indebted. Even if we have not reached agreement on all issues, I think there is a broad consensus on this point, and we look forward to more detailed country specific work in future papers.

Second, Fund staff now accepts that the ratio of net present value (NPV) of debt-to-exports is a key indicator for assessing sustainability (along with the debt service ratio and external financing gap data). We were disappointed, therefore, that data on NPV of debt-to-exports was not included in this round of the staff's analysis. We recognize that the Fund and World Bank staffs have differences of view on the analytical issues. However, the argument that the lack of compatibility between Fund and Bank data is responsible for the omission seems to us a weak justification for such a glaring absence, particularly given the heavy emphasis by Directors at our discussions early in the year that NPV analysis was a critical element in defining the scope of the problem. We would urge the staff to reconcile analytical and data issues at an early date so that a comprehensive analysis including NPV data is available to permit the respective institutions to reach policy decisions.

Third, we were especially glad to see the staff make a first stab at looking at the fiscal burden of external debt. Appendix 1 of the background paper notes that the average scheduled debt service for the group of 41 heavily-indebted poor was 90 percent of government revenue (before grants) in 1994, up from 84 percent in 1990-93. Half of the group faced scheduled debt service payments exceeding one half of annual government revenue. For 13, scheduled payments exceeded total annual government revenue. The gap has been filled in many cases through the accumulation of arrears. This is clearly an unacceptable and unsustainable means of debt management, and the implicit endorsement of this cycle by donors, including the IFIs, is disturbing. It also conflicts directly with the goal of returning these countries to normal relations with the international financial community. Tellingly, the staff's analysis illustrates that for most of the 13, the fiscal policy stance in 1994 could not avert a further increase in the external debt-to-revenue ratio from already high levels. These preliminary conclusions reinforce our belief that the fiscal burden of debt is a serious problem for a number of countries, even if using the most (and probably too) conservative guideline of scheduled payments exceeding total annual government revenue.

Fourth, the paper acknowledges, although does not quantify, that debt overhangs may have hurt growth through deleterious effects on investment incentives and private capital flows in these countries. We look forward to continued work by the staff to clarify the nuances of these effects.

While noting that most of the low-income rescheduling countries will benefit substantially from the application of full Naples terms stock reduction on bilateral official debt, the paper concludes that Naples terms will not be sufficient for several countries. The paper points to continuing difficulties after Naples terms for 8 low-income rescheduling countries, and extremely difficult debt situations for a further 5 countries which have not received concessional reschedulings. This analysis does not include consideration of countries with severe arrears to the Fund. For other low-income countries, the staff notes that their ability to achieve debt sustainability and an exit from rescheduling is dependent on reaching the assumed optimistic export growth or further adjustment. If export growth were lower by 1 percent per annum than assumed, or if external financing is provided at interest rates that are on average 1 percent per annum higher, the paper acknowledges that significant external financing gaps would (not could) emerge for most of these countries. Extending the analysis to include NPV data, as well as fiscal burden indicators, could suggest different lists as well. Pending further analysis, however, we believe that 13 to 20 countries is the ballpark range we see as representing a serious problem.

We recognize that today's discussion is neither the time nor the place to decide what special measures might be necessary to address the heavy IFI debt burdens of these countries. However, it might be useful to look more carefully at some of the concerns that have been expressed in previous Board discussions. First, it has been suggested that an IFI debt initiative could reduce resource availability for others. On the contrary, by reducing the debt burden of countries with heavy Fund debt, their need for new ESAF funding will also fall (though not necessarily be eliminated), freeing up resources for other countries. A second concern is that such mechanisms would shift ESAF resources away from Africa to other regions. The twelve countries with the heaviest Fund debt burdens on a net present value basis are virtually all in Africa, Guyana being the only exception. Some argue that conditionality will be lost. Not so. There is broad consensus that most of these countries will continue to need exceptional financing for balance of payments support, even after they attain debt sustainability.

Invariably, the monetary character of the Fund is cited as precluding us from going beyond ESAF lending on current terms as the Fund's response to the multilateral debt problem. We would note, however, that management has repeatedly said in the past that the monetary character of the Fund is not defined by the terms on which it lends. If this had been the case, we never would have had an ESAF to begin with. As important in the definition are the purposes of the lending, which are to support macroeconomic and exchange rate policies that will achieve sound adjustment.

These issues will receive a lot of attention at the Annual Meetings. Imaginative, yet realistic solutions will be needed. The Fund will need to play a central role in that effort given its responsibilities for promoting sound policies--which are the ultimate solution--and due to the fact that obligations to the Fund constitute a significant share of the multilateral debt burden. We therefore urge the staff to cooperate closely with the World Bank in developing a comprehensive approach to the multilateral debt burden of these countries. While it is premature to reach conclusions on what should be done, it is also premature to rule out potential approaches. We need to consider carefully the longer term benefit of our current strategy and whether reliance on continued financing on current terms is sufficient to achieve an exit.

To conclude with just two points and one question on the private market financing paper, I very much welcome the treatment in the background paper of the need to incorporate more extensive analysis of external debt management in our surveillance efforts. This goes beyond the cases of the heavily-indebted poor to the membership as a whole, particularly those countries regaining or achieving for the first time access to private capital markets. Chart 5 on page 10a raised a flag in detailing the significant increase in international bond redemptions projected for 1996-1998. This will warrant close attention. My final question relates to the discussion of Fund assistance for debt and debt-service reduction operations. We would appreciate some further clarification by the staff of why ESAF loans cannot be used for such purposes, particularly given the possibility that a future ESAF would no longer rely on direct creditor support.

Mr. Issaev made the following statement on behalf of Mr. Kaeser and Mr. Keller:

Let me start by acknowledging the important work that has been done by the staff to detail the intricate debt situation of developing countries, and in particular the most heavily indebted low-income countries; it sheds some light on the question of debt sustainability. (Adequate thresholds for debt stock and debt service guide the assessment of policy options. The country-specific analysis takes into account the fiscal burden of external debt and includes the full range of official debt). In sum, I believe we have now a fairly clear view of the prerequisite and conditions for the countries' possible exit from the rescheduling process.

This view does not imply, however, that all the necessary conditions are already well in place. On the debtors side, adjustment efforts and performance let much to be desired in many countries; on the creditors side, not all the instruments which would be needed are already shaped and working to the extent desired. The availability of financial resources in the adequate quality and quantity is likely to remain a concern for the time being. This is to say that the official debt problem of heavily indebted low-income countries is by far not yet solved.

The agreement by the Paris Club creditors to reschedule on Naples terms has been one of the most important recent developments concerning indebted low-income countries. Under the circumstances detailed by the staff, these terms can give most countries eligible for Paris Club rescheduling good prospects for dealing with their heavy debt burdens. It has to be stressed that this positive assessment critically hinges on the implementation of stock-of-debt operations for countries, which must demonstrate unwavering commitment to economic reform and strong track records of adjustment.

However, the Naples terms do not offer a definite answer to the problems of future external financing of low-income rescheduling countries. These countries, including those that will manage to exit from the rescheduling process, will remain heavily dependent on continued large net resource inflows on concessional terms. Their eventual debt management position--and indeed their development prospects--will very much depend on their success in broadening and diversifying their export base through strong adjustment and structural reform policies. Nonetheless, some low-income rescheduling countries will not be able to achieve medium-term sustainability, even after having been granted a rescheduling under Naples terms.

In defining external-debt sustainability, as differing from the normal Fund definition of medium-term viability, i.e., excluding exceptional financing (such as the use of Fund resources), some confusion may arise. In my view, the level of a sustainable external debt should imply a sustainable balanced external position, where only expected, reliable, and sustained financing flows would be taken into account. The Fund's financial assistance and other exceptional financing can only be temporary, and should therefore not be expected to be sustained over a long period.

I note that the problems of heavily indebted poor countries that are not yet eligible for Naples terms as well as, in particular, the problems arising to the Fund from some prominent members in this group which have large protracted arrears are not addressed. While agreeing that it is difficult at this stage to go further in assessing the necessary mechanisms to deal with these cases, it appears nevertheless useful to start exploring already now ways to deal with them which would go beyond the Rights Accumulation Programs.

Last but not least, I share the staff's concerns on the rapidly rising external debt of a number of FSU countries. While agreeing that their focus on debt management has to be strengthened, I believe that this is not enough. It is not reasonable to let things develop until these countries' debts are ripe for reschedulings. The best debt exit strategy is always not to enter into debt. From now on, all efforts have to be undertaken so that they avoid the debt trap and, in particular, so that they avoid to grant all sorts of guarantees indiscriminately. External financing should only be granted in forms that are in accordance with their expected long-term debt servicing capacity. A last word concerning the staff's assistance for debt rescheduling agreements with non-Paris Club creditors: I very much regret that this assistance has at times rather taken the form of arm-twisting of other Fund members.

To start this discussion, it might be useful to recall a number of basic facts, at the risk of sounding redundant. At a time when private market financing is to play an important role in developing and transition economies, private financial markets do need a certain number of assurances, otherwise it is hardly conceivable that financing is readily forthcoming. Thus, the following four points are of relevance:

First, the fact that a country has a commercial debt problem--or indeed any debt problem at all--is a result of past misjudgments in taking adequate decisions on finance and investment. Such "mistakes" are being made either by the credit offering or by the credit demand side, but most typically by both sides simultaneously. A second remark pertains to the fact that in international credit relations, as well as in other commercial relations, the principle of "pacta sunt servanda" should apply in an unequivocal way. Without having reasonable assurances to this effect, the markets might insist on high risk premia or refrain from lending altogether. Third, private markets, based on their agents' individual risk assessments, need reasonable confidence that a country is pursuing sustainable economic policies. In this area, and regarding the provision of adequate information, the Fund has recognized its responsibilities. Fourth, it is a fact that private market participants have their own way of reacting to anomalies in the above mentioned respects. They are in search of possibilities for profit-making in an often myopic way; they are not driven primarily by a mission to enforce world economic stability or to finance balance of payments gaps--like the Fund. It is thus not astonishing that the private financial markets view fundamental and long-term macroeconomic factors in a way which may, at times, appear irrational to informed Fund staff.

Over the past years, significant progress has been made in resolving the commercial bank debt problems of a number of developing countries. In some instances, market expectations of enhanced potential demand in the wake of debt-reduction operations pushed up secondary market prices of developing country debt to levels above these countries' medium-term debt service capacity. But this is a normal market reaction, which countries have to take into account when preparing for debt reduction negotiations. Against this backdrop, the staff is right to recommend countries to seize the present favorable opportunity to make early progress in negotiating with bank creditors, with a view of reestablishing orderly relations in the framework of a Fund program. Any delays in these respects can only be detrimental to their present and future economic standing.

In some cases, low secondary market discount rates may indicate that the markets expect that a country is willing and able to service its debt to a large extent. There, the markets assess the true value of the debt as well as the country risks involved. If their assessment is positive, such countries--emerging markets--can expect to regain, or to intensify, their capital market access.

I agree with the staff that Brady-type operations remain an acceptable and possibly the most affordable solution for the few cases of low-income countries, where the size and the secondary market prices of debts does not allow other solutions. I trust that in these cases, commercial banks may show the flexibility suggested by the staff, if they feel confident that such concessions are warranted in the framework of a strong Fund program. However, I have some doubts about the Fund supporting such operations through the provision of a small stand-by arrangement. I cannot support the staff proposal of providing stand-by resources to heavily indebted low-income countries. This would be incompatible with the debt-servicing capacity of these countries and would contradict the Fund's recommendation of granting such countries financing only on concessional terms.

The issues related to private financial flows to developing and transition countries have already been discussed at several occasions by this Board. While liberalized capital flows lead to a better allocation of resources, they may also entail a greater vulnerability to external shocks and to the consequences of inconsistent internal policies, and hence they constitute an incentive to introduce early adjustment measures. In dealing with the external debt, it is crucial for a government to carefully monitor foreign capital flows in order to maintain timely information on the economy's overall foreign exposure.

The question of the efficiency with which a country can absorb massive capital inflows remains crucial. Previous staff studies have reported concerns that foreign capital may have simply served as a substitute for domestic savings or may have been used to finance speculative operations, instead of taking the form of more directly productive investment. As banks and the financial system play an important role in the intermediation of inflows, the development of a healthy domestic finance and market infrastructure will be a key element in the improvement of a country's ability to efficiently use imported financial resources. The staff clearly has a role to help countries' authorities provide for adequate bank and market supervision and regulation.

Mr. Tulin made the following statement:

Let me first of all praise the staff for their excellent preparatory work, which resulted in a set of papers rich in factual data and totally relevant, though impressive in volume. The findings of the staff seem to be perfectly adequate to the main trends in official and private market financing for developing countries and their debt situation. I would therefore endorse the main policy conclusions in the staff papers and confine myself to a number of particular observations.

External debt overhang is a very serious problem for quite a number of poor countries. To my regret, the list of heavily indebted countries recently had new entries, including transitional economies of the FSU (e.g. Armenia, Georgia, the Kyrgyz Republic, and Tajikistan). These latter had started their independent development with no external debt (due to a "zero option" with Russia), but soon engaged in unsustainable borrowing. In these circumstances, I would consider it appropriate, on the one hand, to continue technical assistance in strengthening debt-monitoring systems in heavily-indebted countries, and on the other hand, to place stronger emphasis on the terms of new external borrowing within the program periods. Problem countries' capacity to repay the Fund should be addressed in an explicit and realistic way in the future programs.

Empirical evidence suggests a close relationship between ODA flows and the pursuit of adjustment programs--ESAF-eligible countries with Fund programs recorded a much faster growth of ODA than those without Fund programs. This reflects the importance that providers of assistance attribute to a country's adjustment effort and at the same time underlines the catalytic role played by Fund arrangements in mobilizing external financial support.

I very much appreciate the work undertaken by the staff in order to present an overview of the indebtedness of developing countries to Russia (SM/95/228, Appendix II, chapter 2). Many difficulties exist in the collection, processing and reconciliation of data on this issue. The scope of the problem, however, fully justifies the effort: the Russian authorities reported US$114 billion in claims on countries that supply data to the World Bank's Debtor Reporting System.

For understandable reasons, the staff has avoided making any judgment on disputes concerning the coverage and method of calculation of the claims. However, there are issues where judgments may be prompted by common sense--e.g., international financial claims cannot be settled simply through debtors' disagreements about the existence of such claims. Every debtor is expected to demonstrate good faith, which includes a readiness to negotiate.

Let me add a point on the issue of valuation of U.S.S.R. ruble-denominated claims. Russian monetary authorities believe that conversion of these claims into U.S. dollars at the official rate of the U.S.S.R. rubles is absolutely justifiable, in view of the nature and entire context of credit agreements and with a realistic regard for the market value of goods delivered under such agreements. Usage of the ruble exchange rates as a pretext for justifying protracted arrears in debt-servicing must be interpreted as artificial and a lack of good faith on the part of a debtor.

The staff's systemic approach when developing countries' liabilities toward Russia are integrated into the framework of debtors' overall external debt is very welcome. Indeed, Russian claims cannot remain an "off-balance-sheet" item for debtor countries that do not wish to recognize them. Building on the body of information in its possession, the staff can now incorporate data on these liabilities and resulting debt-service flows into the general framework of external financing as it appears in staff reports for Fund program approvals and reviews or Article IV consultations with every individual debtor country. Reconciliation of claims may well take a lengthy period of time, so meanwhile it might be prudent to start by including in the calculation of financing needs the lesser of available amounts.

Let me also note that my authorities do realize the very limited payment capacities of many debtors among developing countries, particularly heavily-indebted poor countries, and have demonstrated a willingness to negotiate far-reaching rescheduling agreements.

Finally, as regards private market financing, the report provides an interesting and realistic assessment of developing countries' possibilities to access private markets. Let me join the staff in their optimism about the insignificant damage which the Mexican crisis caused to most developing markets, especially the Asian ones where fundamentals are strong. Perhaps the "contagion effect" so much spoken of recently is largely exaggerated or at least may have a very short-term effect. Investors are, most likely, capable of adequately assessing economic policies in different countries. After all, the current trend toward reduction of interest rates in most industrial countries may create an additional incentive for investors to look for reliable instruments in emerging markets.

Ms. Srejber made the following statement:

The issues of the Official Financing for Developing Countries and the Private Market Financing for Developing Countries and Their Debt Situation are very much interlinked, as both kinds of the financing have macroeconomic implications to the economy of the countries in question. Thus, I would like to firstly address the things of the general character valid for both items and then go on to more specific remarks.

I welcome the possibility to once again discuss the official and private financing for developing countries and their debt situation, especially on the basis of the very useful and interesting staff papers, which makes conclusions that, to a large extent, match this chair's views.

The crisis in Mexico illustrates that developing countries with chronic excess of foreign expenditures over receipts are highly vulnerable to global economic disturbances and that this can significantly retard development efforts. This vulnerability can also greatly limit a poor nation's ability to formulate and pursue appropriate economic strategies. The implementation of sound macroeconomic and structural programs is therefore highly essential. This was also the prevailing view in, for example, the Board discussion in September, 1994 on Financing for Developing Countries and Their Debt Situation. The problems in the developing countries could be solved only through the creation of a good economic and institutional structure and sound macroeconomic fundamentals. Therefore, the main part of the work to alleviate the severe problems in the low income countries has to be done by the countries themselves through a sound economic policy. Sound economic policy as well as timely information and effective supervision of financial institutions and the securities markets are necessary conditions for access to foreign capital. Capital control should be kept at an absolute minimum as it imposes costs on the economy in general and tends to impede the development of appropriate business practices concerning external debt management in the private sector. Moreover, it is important to establish sound routines for government management of external debt in order to avoid sudden liquidity problems or large losses due to changes in interest rates or exchange rates. The Fund should, in close cooperation with the IBRD, assist highly indebted countries with timely policy advice on external debt management. This is particularly important in transition countries that have experienced an extremely rapid build-up of external debt. I do very much support the staff's observation in this regard, and think that it is high time for the Fund to assist in preventing transition countries from slipping into serious problems in the future. Here I see an important input from the Fund by providing to the authorities of those countries a timely policy advice on the external debt management. Given the less experienced governments of those countries, the Fund and the IBRD could not only help in estimating what constitutes a sustainable level of the external debt as a share of export, but also provide additional considerations on its quality and composition.

Generally, the earlier in the problem phase a reform program is implemented, the more a country stands to benefit from it. We therefore agree that developing countries should try to buy back their debt at a discount or implement a stock-of-debt operation as early as possible.

This chair believes that a proper and timely implementation of the Naples terms represents an important part of the debt strategy of several heavily indebted low income countries. Therefore, I welcome very much the simulations of developments for a number of indebted countries after hypothetical debt reductions based on present Naples terms. Of course, future developments are always highly uncertain, and one could always discuss individual assumptions or the combination of them, but, on balance, the assumptions in the simulations seem reasonably cautious and could serve as a baseline scenario. The simulations confirm our expectations that debt reduction combined with sound policies probably would enable most countries to exit from the debt trap and embark on a sustainable growth path. As noted in the staff report, notwithstanding such debt relief, virtually all of the countries will remain heavily dependent on aid flows. In the current budgetary and political climate, ODA budgets have been retrenched and seem to continue to be retrenched, according to common view. However, over a wider timespan, for example, 1984-94, as shown in the staff paper, ODF have grown. As I have said before, the causes and consequences of the latest developments are open to analysis, and recent developments do not lead up to straightforward conclusions about likely longer-term trends in the volume or, maybe more importantly, the effectiveness of ODA flows over the medium term. Although the decline in net ODF since 1993 is indeed very worrisome, this might to some extent be balanced by increased efficiency as some of the donors move away from the cold war geopolitical determination of priorities to criteria based on development objectives. That concessional flows are now increasingly being directed to countries pursuing Fund supported programs, which indeed have been outperforming those without programs, could be an indication of increased effectiveness of the flows.

Some developing countries however are facing such a high debt-service burden that Paris Club stock-of-debt reduction operations are not sufficient to achieve medium-term sustainability. Such countries would need higher new capital on concessional terms or further reductions in debt. However, there are fairly large differences in composition of debt and adjustment efforts among various low-income developing countries. It would therefore seem appropriate to adopt a flexible approach based on a case-by-case evaluation of each country with the aim to ensure a durable exit from the rescheduling process.

As comes to the role of the Fund in these countries, we must not forget the monetary character of the Fund. The Fund should try to maintain its main catalytic functions when dealing with the issue of external debt in developing countries. Thus, this chair stresses the importance of the Fund's policy advice and surveillance of the developments in the members countries, as well as the Fund's contribution to assessing the macroeconomic impact of member countries' debt situation. We would advocate continued concessional lending to the low-income developing countries, with the Fund playing a catalytic role. The main part of the financing should be provided by other creditors based on strong appropriate The Fund conditionality.

Since the Board discussion in September 1994, further progress was made by several additional countries on the debt deals with their commercial bank creditors. It is a welcomed development that, as of end-July 1995, a total of 21 countries had completed debt and debt service reduction operations, restructuring a total of $170 billion in commercial bank debt, and several more countries are in the process of resolving their commercial bank problems. The encouraging fact is that a number of low income countries had also made progress in restructuring their bank debts. However, we agree that more efforts should be made for the countries which have relatively large commercial bank debt obligations.

This chair agrees with the staff's suggestion that a flexible menu approach involving among other things the sale of debt on the secondary market at a discount continues to be an effective way of dealing with developing countries' debt problems. Many low-income countries have, however, in spite of the fall in secondary market prices, not been in a position to repurchase their debt. For these countries, I would think that it should be investigated how support could be provided under existing facilities, instead of merely searching for further support arrangements. Here again the advice for continued access to international sources of private capital is to go further with strong economic performance, determined and strengthened by structural adjustment efforts and professional debt management.

The situation of managing of external debt can be complicated additionally in the countries where the private sector and public sector corporations are very active in international capital markets. Thus, difficulties in the above mentioned sectors can have implications for macroeconomic policies. Having this in mind, the government must have timely information on the economy's overall foreign exposure, in order to assess the appropriateness of the macroeconomic policies. This underscores the crucial importance to collect and publish accurate statistical information on the state of the domestic economy and the country's external position on a timely basis.

Mr. Evans made the following statement:

First, I welcome the set of papers that the staff has produced on these important issues. But I cannot endorse the suggestion that material in the official financing paper and background paper should be published at this stage. I take issue with both the analysis and its presentation: both tend in my view to underestimate the extent of the debt problems of the heavily indebted poor countries.

The staff notes that bilateral aid is falling, and that this will increasingly affect multilateral resources--particularly IDA--something that might have been spelt out more clearly in the paper.

I found the paper's treatment of the share of multilateral debt outstanding a little biased in favor of minimizing the problem. The paper should note that, for heavily indebted countries, multilateral debt has risen from $26 billion in 1985 to $61 billion in 1994.

But, as the staff points out, this must be seen in the context of increased levels of multilateral lending on increasingly concessional terms. We welcome that shift. But without greater concessionality for certain severely indebted poor countries, or action on outstanding debt stocks, increased multilateral flows may add to the overall debt burden: this is well illustrated by the later analysis in the papers.

The paper rightly emphasizes the stark reality that there is little prospect that most low-income rescheduling countries will be able to graduate from the rescheduling process in the absence of Paris Club stock-of-debt operations.

I would also underline the importance of comparability to Paris Club treatment of SILICs by other bilateral creditors. The principle of burden sharing is crucial to success of Naples Terms.

The staff suggests that Naples terms by the Paris Club, with comparable treatment from other bilateral creditors, offers the likelihood of a durable exit from reschedulings. Equally important, of course, is the recognition that for some countries, the generosity of Naples Terms will not suffice. Further action will be needed: this might include higher debt relief from the Paris Club and other bilateral creditors, as well as action on multilateral debt. The UK has proposed debt reductions by the Paris Club of up to 80 percent on an exceptional basis.

I have a number of comments on the analysis of the external debt sustainability of the heavily indebted poor countries.

Once again, the work seems to rest on optimistic assumptions regarding exports. It is not prudent to project export growth rates of 8 percent per year, year after year, until 2014. The export growth projections do not include the possibility of adverse trade shocks which should be taken into account for this group of countries. The projections of future aid flows should allow for real declines in flows. I note that some of the assumptions are based on PFP scenarios: but this is to take the usefulness of PFPs--which are designed to inform policy making over a much shorter period--way beyond their useful limits.

As I argued earlier this year, it is not enough to look, as the staff paper does, at a flow analysis, which has to be based on uncertain projections over a long time-horizon. In addition, we need to look, as the World Bank does, at the net present value of a country's debt stock.

Of course the Fund's analysis does include some reference to debt stock indicators. But I was surprised to see that the methodology behind these debt stock indicators is different from that we have been using, including during our multilateral debt discussions earlier this year and in the Paris Club forum. I do not wish to get into the technicalities here, but--briefly--the denominator in the NPV ratio has been altered from being a measure of current levels of exports to being a measure of future levels of exports. In addition, the new NPV methodology includes debt service payments just over a 20 year period, as opposed to the full stream of future debt service payments. Because the maturity period of many concessional loans extends beyond 20 years, this change in methodology is significant. These changes alter the whole basis of the indicator, and I estimate that it could reduce NPV debt stock ratios by about 25 percent. I am not seeking to make a judgment about which might be the better of the two methodologies, but I am particularly concerned that we should not be misled into looking at these indicators on the basis of benchmarks (the 200 and 250 percent benchmarks) which would seem to be irrelevant here.

I believe that these concerns raise strong doubts about the conclusions of the exercise of the 14 countries, which the paper highlights in its conclusion, and on which it bases its recommendation to continue with the status quo. The prospect of the need for immediate action outside the current framework is suggested for just a handful of countries: Mozambique, Nicaragua, Zambia, Guinea-Bissau and possibly Sierra Leone.

Is four or five a useful indicator of the size of the problem? It is clear from a close reading of the paper that it is not. That would gloss over rather too readily the fact that the study does not even include many of the worst HIPC cases--as identified in previous studies. These countries include Madagascar, Cameroon, Burundi, Rwanda, Angola and São Tomé and Principe, as well as some of the prolonged arrears cases with extremely difficult debt situations: Zaire, Somalia and Sudan. The presentation of this point needs to be greatly improved.

In addition, as noted above, I am not confident that it is meaningful to take any of the countries passing "the sustainability test", in the Fund's analysis, out of the problem category. In particular, I would note that 4 of those countries are also likely to face problems over the medium-term at least--on the Fund's own calculations: these countries are Bolivia, Guyana, Honduras and Uganda which, according to the projections presented by the Fund, are likely to face debt service burdens of 20-25 percent which will persist over at least the next 8 years. This is a point made in the background paper but is not taken through to the conclusions in the main paper. On this point and others, I found the key summary box in the main paper--Box 10--to be unclear and it does not fully reflect the earlier analysis.

In sum, when looking at the paper to try to get a sense of the real scale of the problem, my view of earlier this year remains that we are looking at a group of some 15 countries that might be candidates for help outside the current framework of policy options, plus possibly 3 of the prolonged arrears cases over a longer timescale.

Of course, I can welcome the Fund's commitment to focus on debt sustainability rather more in the future. But given my doubts about the current analysis, I rather fear that we might be disappointed with this work. In particular, we must not rely on highly uncertain projections over long periods. I also find the "targets" for debt-indicators to be a little on the high side--certainly compared with the target indicators that the World Bank has been using hitherto.

Beyond the analytical difficulties, there are serious questions about policy instruments. We continue to believe that the Fund must look seriously at innovative ways in which it can help this group of countries.

I would now like to turn to the work that the Fund has taken forward on an aspect of a country's debt problem which is more difficult to quantify: the debt overhang and its "dynamic effects" on investment and growth. I welcome the assurance this work will be taken forward in country-specific work in the context of sound programs. The work so far does not contradict my belief that debt stock reductions should have dynamic effects on investment and growth, by increasing certainty and improving the environment for policy making and private investment.

Finally, turning to the papers on private financing, I commend the staff for the useful information these papers contain, in particular on the effects of the Mexico crisis. I would like to comment on two points.

First, on Fund support for DDSR operations for ESAF-eligible countries. The paper suggests that Fund might play a financing role in the form of a parallel SBA to an existing ESAF arrangement, where this would be appropriate given country's debt servicing capacity etc. The paper notes that ESAF financing for such purposes is outside the scope of ESAF rules. A more important question is whether it would be appropriate for ESAF funds to be used for this purpose. I would highlight that the mechanism for Fund help suggested here might actually be very rarely relevant, given the non-concessional nature of SBAs.

Second, export credit policy should not overlook an importer's circumstances so as not to add unduly to debt burdens of developing countries. This is in the long-term interests of both developing and developed countries. Particularly for countries emerging from financing difficulties, it is also important that export credit is used for productive purposes. The UK would like to see this issue addressed in the OECD Export Credit group. In this context we welcome the recent Fund work on unproductive public expenditures.

Mr. Newman expressed his concern over the staff's proposal that the two papers on official financing for developing countries and their debt situations be published. On the one hand, the Fund was the principal source of information for the public on trends in official financing to developing countries, and that type of material had been published for some time. On the other hand, the discussion of the debt problems of the poorest countries was preliminary. Moreover, despite agreement on the key policy issue that the debt overhang was a serious problem, analytical differences existed between the Fund and the World Bank staff on measurement questions. The publication of a paper that recognized the debt overhang problem but gave a one-sided presentation of its significance, without the analytical background which Directors had requested, could fuel perceptions of wider disagreement between the two institutions than actually existed. It could also deflect attention from the key issue at the Annual Meetings of the role of international institutions in addressing the debt problem. The unfortunate leak of the World Bank staff paper had exacerbated that difficulty. In light of recent developments, he looked forward to the views of other Directors on that issue.

The Chairman said that the international press had created an impression that the World Bank and the Fund differed on debt issues. To avoid any misunderstandings, the Fund should exercise caution in timing the publication of the two staff papers under discussion.

Mr. Evans, noting the unauthorized disclosure of the World Bank's paper on external debt, and the series of recent articles on the subject in the Financial Times, the Economist, and the Washington Post, wondered whether it was prudent to publish the staff papers at the current juncture. There were differences of opinion both within and between the Fund and the Bank on the matter of external debt, and the Fund should ensure that publication of the papers would not exacerbate the existing problems. Furthermore, the External Relations Department should note that the Bank document leaked to the press had not been a statement from the management or the Board, but a proposal from a group of Bank staff members.

The Chairman replied that the Bank and the Fund were in the process of studying the external debt problems of members and were coming to some preliminary conclusions. As the Bank and the Fund had not taken definite stands on the issue, it was perhaps not correct to say that there were differences of opinion between the two institutions. In fact, with a view to strengthening cooperation, the heads of the two institutions had agreed to work together and, despite the current setbacks, cooperation would be enhanced in the future. The different mandates of the two institutions would not prevent them from working together to address common problems of the membership.

There were no major analytical differences between the approaches of the Bank and the Fund, and the Fund staff had worked in close collaboration with the Bank in preparing the paper under discussion, the Chairman remarked. In that regard, he had been surprised to note that Mr. Evans had considered that the Fund's paper had underestimated the extent of the external debt problem faced by many countries. The country-by-country projections reported in the paper had been compiled on the basis of policy framework papers, which had been formulated by country authorities in close collaboration with the Fund and the Bank. Thus, on the basis of common projections, the staff had given a realistic assessment of the prospects for medium-term debt sustainability of the heavily indebted poor countries.

The Director of the Policy Development and Review Department commented that, over the previous ten years, the Fund had regularly published papers on key external debt issues, which provided the only comprehensive source of information on policies regarding official debt relief, and the historical record of Paris Club reschedulings. The intended publication in 1995 would have a summary of recent developments and an analysis of debt sustainability that would be based on a revised versions of Chapters 2 and 3 of the current staff paper. The contents of the current background paper, appropriately revised to exclude any sensitive material regarding the options that might have been chosen by certain creditors in the Paris Club, would form an important part of the intended publication. As the Fund and Bank staff had worked in close cooperation in developing the papers, no further problems were expected at the publishing stage.

Both the Fund and the Bank had viewed the study of external debt as an evolving concern where there were no final conclusions, the Director observed. At the current stage of investigation, any conclusions could only be indicative. The Fund and Bank staff agreed that, for the case-by-case approach, an analysis carried out for Uganda in the Bank's recent country assistance strategy paper was the most appropriate. It had been agreed to use that methodology to produce a debt sustainability analysis for each of the country case studies that would be brought before the Board.

During the previous nine months, the staff had drawn the Board's attention to the dismal prospects for bilateral aid, the Director noted. In the paper presented to the Board in the spring, the staff had emphasized that, as a result of budget constraints and political developments in some of the donor countries, aid in real terms had declined in recent times. Therefore, it had been assumed that most countries covered in the staff paper would experience declines in bilateral aid receipts in the near future.

To ascertain the importance of obtaining from bilateral creditors conditions comparable to Paris Club terms, an analysis had been carried out assuming a 67 percent debt stock reduction for all other bilateral, commercial, and official debt of the heavily-indebted countries under study, the Director remarked. A separate analysis had also been carried out for Russia and its claims on other countries.

As regards the relative generosity of Naples terms, bilateral creditors might need to do more to alleviate the debt situation of the heavily-indebted poor countries, the Director stated. The staff believed that some "topping up" and "a broadening of the debt covered," including previously rescheduled debt, would have to be undertaken under Naples terms.

Most economists generally debated the assumptions underlying the debt projections, the Director observed. The assumptions on export growth for the 14 countries were based on policy framework papers, which had been approved by the Board. Because the scope of those papers was limited to the medium term, for undertaking 20-year projections, assumptions on export growth and other critical parameters had to be made on the basis of information obtained from Board-approved documents.

The net present value of the external debt for all 41 countries was shown in Table 6, the Director noted. The net present value of debt had also been calculated for each of the 14 countries for which 20-year projections had been carried out. Although the projections had been reported in the background paper, they were not highlighted because they were based on partial calculations, which did not fully reflect the impact of IDA borrowing with maturities exceeding 20 years.

The results of an alternative calculation of Uganda's debt and debt service payments--using a methodology preferred by both the Fund and the Bank staff--had been reported in the Bank's country assistance strategy paper, the Director remarked. In that case, the path of the net present value of the debt stock had been tracked over time in a dynamic manner, taking into account new borrowing and the associated debt service, and export projections for each year. The results summarized in the footnote on page 21 had shown that the net present value of Uganda's net debt stock would decline from 318 percent in 1995 to 150 percent in 2002.

The net present value calculations of the Fund and the Bank had given basically the same results, as both institutions used the same concepts and analytical foundations, the Director stated. The Fund staff had had some difficulties with an earlier calculation of net present value of debt presented by the Bank for identifying countries for detailed analysis. In that case, the Bank had based its calculations on historical export figures for the period 1991 to 1993, which had not taken into account the export prospects of the countries. A straightforward application of the analysis to countries such as Uganda and Peru would fail to capture the dynamism of their export sectors.

It was risky to use a single number to characterize complex debt problems of countries, the Director observed. For example, the net present value concept failed to capture heavy bunching of debt service payments. An examination of yearly debt service ratios was required to find out when a country would experience problems. In that regard, the Fund and the Bank had agreed that it was necessary to look at a number of aspects--as shown in Box 8 of the paper--including net present value of the debt stock, debt service ratios over time, and funding possibilities. Many of the countries that would have serious debt-service problems had been listed in Box 10.

Mr. Mirakhor noted that eight more countries not "yet" eligible for Naples terms had been identified in footnote 7 of Table 6. He wondered why the staff had used the term "yet." He also wondered whether there would be more countries not eligible for Naples terms than had been identified so far.

The staff representative from the Policy Development and Review Department replied that the criteria for forming groups consisting of 41, 27, and 14, countries were explained in Box 1 and in Table 1 of the paper. The countries referred to in footnote 7 of Table 6 were included in the last group of Box 10, with one exception. For some of those countries, Paris Club creditors would likely agree to Naples terms, which would have the effect of reducing their overall debt burdens. However, some others--like

Ghana--had adopted policies, which were not based on the assumption of some future Paris Club rescheduling.

Mr. Evans agreed that no single number on its own could reveal the dimensions of the debt problem. Under the circumstances, he would prefer not to attach too much importance to long-term projections. First, such projections could go wrong quite easily. Second, he recalled that during the debt crisis in the mid-1980s, many projections, including those of the Fund and the Bank, had shown that countries in Latin America could solve their debt problems, provided certain conditions were fulfilled. In practice, the required conditions had not been fulfilled for many countries. For finding a lasting solution to the debt problem, it was far more important to have a clear picture of the current magnitude of the debt faced by countries than to rely on uncertain projections of its future profile.

Mr. Mesaki made the following statement:

The results of the analysis are encouraging: they show that stock-of-debt operations on Naples terms, combined with comparable treatment by other bilateral official and private creditors, offer good prospects for the achievement of overall external debt sustainability and an exit from the rescheduling process for the majority of low-income rescheduling countries. I would note that both the cooperation of the non-Paris Club creditors and the efforts of debtor countries are crucial for this exit strategy.

In order to deal with the countries for which the current Naples terms would appear insufficient to achieve debt sustainability, it is critically important that those countries that pursue ambitious adjustment and reform programs are able to obtain sufficient external financing to attain their growth potential while they are receiving flow rescheduling from the Paris Club.

As for the heavily indebted poor countries that are not yet eligible for Naples terms rescheduling, it would be premature to make an assessment of their prospects of achieving sustainability and an exit from the rescheduling process through stock-of-debt operations, in light of the lack of track record of adjustment and the magnitude of uncertainties surrounding these countries.

On the problem of multilateral debt, I would like to make two points. First, although the amount of debt is increasing both in the developing countries and in the heavily indebted poor countries, the debt-service ratio of the multilateral debt is stable in both categories. Second, the results of the sustainability analysis in the staff paper suggest that the overall level of external debt, including multilateral debt, will be manageable for the majority of the heavily indebted poor countries. These two facts--although the latter is dependent on some assumptions and should therefore be cautiously evaluated--support the conclusion reached at the last Board discussion in April.

Also, the fact that almost all the heavily indebted poor countries will remain highly dependent on concessional aid flows supports the view that the continuation of the ESAF should be the centerpiece of the Fund's strategy to deal with the problem of heavily-indebted countries, including the multilateral debt problem.

The staff suggests that there are several countries that will face a relatively high debt-service burden even after stock-of-debt operations, partly owing to their high multilateral debt. I suggest that this problem should be fully discussed with the World Bank and other regional development banks, because the proportion of debt to the Fund in the overall multilateral debt of the heavily-indebted poor countries is relatively small.

As for the arrears cases in which the debt burden to the Fund might be the most serious, it is premature for the Board to discuss ways to fund clearances of arrears as there are no immediate prospects for the initiation of a rights accumulation program for these countries.

Regarding the problem of external debt in some of the FSU countries, I share the staff's view that debt monitoring and management needs to be strengthened in these countries and that the Fund should help these countries to reach appropriate debt-rescheduling agreements with their non-Paris Club creditors.

Let me turn now to the discussion of private-market financing.

First, I note that in 1994 and the first half of 1995, thirteen countries reached agreement with commercial bank creditors. I welcome this progress in resolving the commercial banks' debt problem under the menu approach and I hope that the countries that have not yet resolved their problems can take advantage of the current favorable market situation and reach an early agreement.

Second, the staff suggests that in the event debt buy-back is difficult for some low-income countries because of the high bond prices in the secondary market, the debt service reduction operation may have to be considered. In this case, substantial support from multilateral institutions and bilateral donors is crucial and the Fund should help these countries by recommending sound macroeconomic policies and strong structural adjustment through Fund programs and providing the necessary resources for the operation in an appropriate and timely manner. In this context, the idea of providing a small stand-by arrangement in association with an existing ESAF arrangement might be appropriate as long as these countries have the capacity to service a certain amount of nonconcessional debt.

On the issue of international capital markets, the staff makes the following two points. First, experiences in Asian markets after the crisis in Mexico suggest that basic economic fundamentals are the primary factor determining investors' behavior and point to the importance of countries consistently implementing sound economic policies. Second, continued strong performance and adjustment efforts by a number of countries, accompanied by Fund assistance, contributed to keeping investors' interest in developing country securities.

Regarding the first point, while I basically agree with the staff's view, I note there are several different views on this point among our colleagues. For example, at the last Board discussion on the World Economic Outlook, Mr. Evans said that it was encouraging that the Mexican crisis had made investors more discerning. On the other hand, Mr. Waterman suggested that although investors had become selective against Latin American countries, they had not with Asian countries, and in this sense the lessons from the Mexican crisis had not been fully utilized.

As for the second point, I suggest that we should recognize that the lessons from the Mexico crisis have not necessarily permeated all of the developing countries.

Regarding the management of external debt, I can go along with the staff's view, including the points that debtor countries should take the exchange rate risk in connection with their official borrowing into account and that the authorities should be well informed as to the foreign borrowing of the private sector.

Finally, I endorse the staff's proposal concerning the publication of material in staff papers and background papers, except for certain sensitive information. On this point, I strongly endorse the Chairman's statement this morning.

Mr. Ismael made the following statement:

The staff has presented us with excellent papers on the debt issues. The papers are brief but well formulated, and accompanied by well-researched background papers. However, the papers on private debt would address policy areas more clearly if a breakdown is provided on private debt financing of the low income and middle income countries, to provide a comparable complement to the paper on official financing. I also welcome Ms. Lissakers's statement; it is refreshing, and I can agree with most of what is in it.

From what I have observed, it is probably correct to say first that that the debt situation of the poorest countries have not been improving; it may, in fact, even been worsening. Second, the major debt service burden for these countries is to the multilateral agencies. Third, after the series of measures designed to ease the debt burden of the poorest countries is implemented by bilateral donors, further action should be sought from the multilateral agencies. Considerable effort must, therefore, be made to improve the situation of the poorest countries in order to improve their social and economic environment; it cannot be forgotten that large populations are currently living under the absolute poverty level. The multilateral institutions should make every effort to find a lasting and sustainable solution to the debt problems of the poorest countries. Previous efforts from the official sector in this regard have tended to be short-term solutions implemented over a period of a few years only. The time has come to find a genuinely lasting global solution for the heavily-indebted poor countries.

The main argument against such a comprehensive approach has been that creditors should be able to monitor and control the implementation of adequate adjustment policies organized with the World Bank and the Fund. This approach has, however, not been particularly successful and has resulted in frustration and discouragement for those involved, particularly for potential investors in the private sector. Moreover, repeated debt rescheduling give the impression to the developed world that the poorest countries will never recover from their economic and financial crisis; these countries can, as a result, become ignored and abandoned by potential private sector investors.

The fundamental objective should be the restoration of economic growth in these countries. Such growth cannot, however, be assured only by marginally increasing grant levels and offering improved concessional terms in official sector financings. It is only by improving the medium-term outlook for these countries that the expectations of potential foreign investors in the real economic sectors--i.e., direct investment--and those of local entrepreneurs will become more positive.

Given the current situation with the poorest countries which has developed over many years of inadequate short-term solutions, the time is probably now right to state strongly that there needs to be a significant change in the approach to the overall problems of indebtedness of these countries. Such a new approach should have the following characteristics.

First, debt elevation should be seen as providing a global and lasting solution to the poorest countries' debt situation. It should, therefore, deal with all aspects of and the entire stock of their debt rather than only windows of consolidation covering a few years.

Second, the objective should be to structure a sustainable debt burden over the long term which is based on the most realistic, if not even pessimistic, assumptions. The idea would be, to use a medical analogy, not to give a bit of oxygen from time to time to keep the patient alive, but rather to provide enough support for a lasting recovery, which should include a healthy safety margin in the economic and financial projections.

Third, such objective implies that the multilateral debt element of total debt should also be included in the consideration of debt alleviation and restructuring of the poorest countries.

Fourth, this means that, along with Paris Club rescheduling, nonconcessional and insufficiently concessional multilateral debt could be refinanced, matching maturity and interest rates, with concessional IDA-type financings, and existing Fund facilities could be systematically replaced by ESAF financings.

The World Bank is now in the early stages of considering the possible establishment of yet another facility to reduce debts of the poorest countries. The Fund should do likewise within the constraints of its monetary character. However, it should not hide behind this illusive "monetary character," nor use it as an excuse to evade taking a fair share of reducing the heavy burden of its poorest members. The Fund can similarly begin considering the possibility of another facility of similar purpose, funded by the sale of some of its gold holdings. Its major contribution, however, would be to find ways to extend ESAF and improve the concessionality of ESAF loans. Since the objective of ESAF is to assist member countries overcome balance of payment problems, the question that arises is why is its use for reduction of debt from private sources not permissible when this represents one way of adjusting and improving the member's balance of payments problems?

Mr. Mirakhor made the following statement:

The most important analytic issues raised by the staff papers have been discussed in the helpful grays and I will not address them here. Instead, I wish to focus on solutions to the debt problem of heavily indebted low-income countries.

Mr. Ismael's comments on the role of the Fund is misunderstood, let me say that we cannot support attempts at pressuring the Fund into positions which its management does not think prudent for the institution. In this context, Mr. Clark's gray makes two very helpful suggestions that we support. First, that we cannot and should not ignore countries for which sustainability is definitely in question and, second, that a comprehensive solution to the problem, rather than a case by case or piece meal, approach is required. He is quite correct in asserting that the Fund "must work with other multilateral financial institutions and other creditors to develop a comprehensive solution."

The staff paper makes a clear case for a bold new initiative to help low-income countries to deal with their debt problem. Such an initiative, to be developed not only by the IMF and the World Bank, but also other multilateral and regional institutions as well as the creditor countries, must have the full support of the low-income countries as well as the major industrial countries. The countries addressed by the common strategy should be identified from the very beginning much like the "Baker list" of 15 heavily indebted middle-income countries used under the debt strategy.

What could a package contain? At least three elements come to mind. First, as Mr. Mesaki suggested, the centerpiece of the package should be an ESAF-type program with longer duration; perhaps five years instead of three. Second, such a program should be based on a PFP-type document but more comprehensive to include other multilateral and regional institutions. Finally, in each country a resident office should be created to house representatives from all multilateral and regional institutions concerned to permit a close monitoring of developments in these countries.

What could be the role of the Fund in such a package? The institution could create a permanent ESAF-type facility financed by IMF resources and subsidies through the sale of gold and refunds from SCA2. It could also use the flexibility provided by the Articles of Agreement to postpone repurchase obligations under the provisions of Article V Section 7(g). There is one more thing the Fund can do. The Fund could use any premium over the rate of charge on use of GRA resources to finance debt reduction for low-income countries as part of the comprehensive package. I have already stated my position on the inadmissibility of justification for the rate of charge as a device to lower the risk of moral hazard. However, in the past the U.S. chair has argued for the increase based on an entirely different ground, namely, part of the wedge between the rate of charge and what the members would have to pay commercial lenders, i.e., the so-called subsidy wedge, can be captured to provide the Fund with additional income. I know that the staff is to look at this issue and do not wish at this time to second guess their findings and recommendations. However, should the staff find the increase in the rate of charge practicable, then using it to finance debt reduction for low-income countries is well within the spirit of the cooperative character of this institution. The proceeds from this source could be used to set up a fund whose purpose would be to purchase the currencies of targeted low-income countries held by the IMF for their eventual return to the country concerned. I believe that such an operation is sanctioned under Article V, Section 7(h). but I look forward to staff's reaction.

What could be the role of creditor countries in such a comprehensive package? First, they could coordinate their own bilateral debt reduction effort within this comprehensive approach and, second, they could, in addition to their own support of the debt reduction, contribute part of their share of any SDR allocation to reconstitute the reserves of the low income countries.

Here again there are some very useful discussions in the grays, therefore I will only have one question and one comment. I wonder if there is, either in the Fund or elsewhere information on how many countries have in place comprehensive debt management system and if the staff intends to, perhaps in conjunction and cooperation with the World Bank, provide technical assistance for countries that need such a system.

Finally, perhaps as part of the surveillance process the staff could include discussions of debt situation of members. I realize this is done in case of some countries, but generally after there is already stressful situation. Perhaps debt surveillance could become a regular feature of Article IV consultation in general to cover all members.

Mr. Geethakrishnan made the following statement:

Having spoken at length on this issue on earlier occasions, today I think I can be brief. I have three points to make.

First, as Mr. Boorman pointed out right at the beginning, in our earlier discussions we noticed how the bilateral aid flows are decreasing in real terms. We note it as a fact of life. The papers today circulated indicate that even within this steady decreased bilateral flows, a large proportion is flowing to countries in transition and to post-conflict cases. This also we note as a fact of life. A corollary that flows is that even for a group called sub-Saharan Africa, the bilateral aid flows are decreasing; even the percentage is decreasing. This has also been brought out here. I would like us to note it.

The problem that I have is the way in which it has been defined in the staff paper. Possibly sub-Saharan Africa represents a group of countries where the poverty is maximum, so I would note that the bilateral aid flows are not necessarily linked to poverty as a major consideration. I draw attention to this because on page 14, below the box, it says, "With decreased emphasis on geopolitical concerns, donors see greater scope to adopt aid policies to be more consistent ... with a renewed focus on reducing poverty, among other things." I think this characterization is not appropriate. I do not have any quarrels about donors shifting the emphasis to the countries in transition or to the post-conflict cases--I cannot have a quarrel; it is their decision--but that I would consider it as a geopolitical decision. Let us not now say that with the decreased emphasis on geopolitical consideration, emphasis on poverty is a main criterion in determining aid flows. If that were true, then a decreasing level of bilateral aid flow to sub-Saharan Africa would not have taken place.

My question is not on the facts, but on this characterization by the staff. I would like us to accept that with increased geopolitical consideration, there is an increase in bilateral aid flows to countries in transition, and to post-conflict cases. Let us accept it, that there is decreased emphasis on sub-Saharan and other cases. This is the first point.

The second one, while the bilateral flows to sub-Saharan Africa has gone down, the multilateral flows have increased. This is what has been brought out clearly. This is a very good development. And considering that the bilateral donors have a major say in the decision-making in the bilateral and the multilateral institutions, I see it as a very good pattern that the bilateral donors recognize that while their direct lending to these poorest countries could go down, they are using the multilateral organizations, where they have a major say, to use these institutions as an instrument for addressing the problem of poverty in an increased measure. It is a very good development. I do not think this is an accident. I would say it is a policy direction. If that is so, I think we need to take note of that.

In what way? If the bilateral aid flows to the poorest countries, the developing countries, those of sub-Saharan Africa, etcetera, is going down and if we have to play an increasing role, not only the World Bank, but the Fund, we need to build it into our forecasts, in the projections. As an organization we cannot say that this year we have given $10 billion, and so next year we would like to give $15 billion, because it would be self-defeating. It would be an admission of defeat, because if our policy advice is right and if everybody accepts it, in fact our lending, i.e., the borrowing from us, should go down. We cannot have a priori starting point that next year we would give much more, i.e., $15 billion, because that would very seriously question our effectiveness in advising countries to normalize their position.

But where I would like us to take this into account is not in predicting that next year we are going to lend so much more, but building it into our estimates of resource augmentation for the future. Normally, when we talk in terms of augmenting the resources, we take into account only a possible Mexico II, III, or IV, and get terribly worried about it. I would like us also to build into those estimates the possibility that the traditional set of developing countries, particularly the low-income group, highly indebted countries, may require much larger support from us, and provide for it in our calculations of resources augmentation. We may not publish it, saying that next year we want to increase our lending to these countries by 25, 30 percent, because that would be counterproductive. But we should be prepared for it.

My third and last point, is on the extent of the problem. In our discussions so far we are concentrating on whether it is 4, or 7, or 10, or 18, or 41 countries that are heavily indebted. We also found that the difference lies in the perception of what is likely to develop in the near future in terms of Paris Club concessions, in terms of other developments in these countries and so on. I would go along the lines that Mr. Evans suggested earlier, that this has become a guessing game. It is better not to indulge too much into it and not express too much hope. I would not so much look into the number, whether it is 4, 7, 10, or 14, but I would like to accept the fact that as of today the problem is fairly large. As of today, perhaps it is not limited to four countries, but it is a much larger number of countries. I would like to leave it at that, and see what is it that we are required to do about this. These papers correctly do not go into this question of what should be the Fund's response, because that has been discussed in other forums on earlier occasions.

Broadly, our response has been to think in terms of--I say "to think in terms of" because we have to come to a final decision--of putting the ESAF on a slightly more permanent footing. We are ready to take a decision, but this is our broad thinking. We would like to move in terms of putting the ESAF on a more continuing basis. I would call it "more permanent." We are not thinking in terms of "permanent" forever, but giving it a slightly long-term stature.

In this discussion there have been suggestions from some of us, including in the staff paper, that maybe the maturities could be longer. There are some of us who have suggested, though it has not been acceptable to others, that maybe there should be also an element of debt waiver. It is in this context that I am very much interested in the leak of unauthorized, of unapproved papers of the World Bank. Let us assume it is unauthorized, of unapproved, just being the work of several staff members. Market gossip has it that in the World Bank the staff has a much greater flexibility of discussion of views, much greater than in the Fund. But even so, I do not expect that a group of staff members, even in the World Bank, in a totally free atmosphere, would have spent so much time and effort in preparing a paper which talks very specifically in terms of $11 billion and so on. There must have been some thinking, at least, in the World Bank, not necessarily formally stated by the management, not yet approved by the Board or the Board of Governors, but maybe they are thinking in this direction, and I am interested in this. As the press have been able to get at a copy of this leaked report, I am sure our staff who are also equally capable, have a copy of this report. I want them to look into this report and clarify one thing. If as reported in the press the World Bank is thinking, in an unapproved, unauthorized manner of a large amount, let it not be $11 billion, let it be $10, or $12, to be set apart for debt relief, and according to the pie chart given in the newspapers it covers also the lendings by the Fund--in other words, the World Bank will be generous enough to set apart a large sum of money even to write-off some of the loans due to the Fund, then I would like to encourage it. We have some common members. I would like Mr. Autheman, Mr. Evans and others who sit there also, to encourage this thinking because it will enable us to protect our monetary character, and move away from the discussion on whether or not we should have a write-off provision and, concentrate only on our ESAF. If somebody else is willing to pay for our write-off, very good. Let us welcome it. Let us encourage them, so that we are able to concentrate on the limited task of making ESAF a little bit more permanent. So my interest in this so-called leaked unauthorized, unapproved document of the World Bank is, if there is a thinking that they will pick up our part of the bill, also, then I would like to encourage it and drop it from our discussions so that we are able to look at our part of the proposal within the strict field of the monetary character that we have and try to see how the ESAF can be put on a more permanent footing, without getting sidetracked into issues like whether or not we should do the debt write-off, whether it should be funded or financed by the gold sales, or the reflows, etcetera. We need not get into this if somebody else is willing to pick up the bill.

Ms. John made the following statement:

The papers presented by the staff offer a very comprehensive assessment of the position with respect to the financing situation of developing countries and their debt situation. A few comments on some of the issues raised:

We agree that substantial further progress has been made over the past several months in establishing a framework for normalizing the debt situation of developing countries. The agreement on Naples terms and the possibilities that stock-of-debt operations offer for some developing countries to achieve debt sustainability and an exit from the debt- rescheduling process represent significant progress. We note, however, that for some countries, their debt would remain far greater than their capacity for debt service and also that many low-income developing countries would remain heavily dependent on aid flows. We, therefore, regret the decline in ODF and urge that this trend be reversed as early as possible.

We encourage the Fund to seek, under its current guidelines, to continue to assist countries which are pursuing strong adjustment programs. We therefore support the staff proposal to assist poor countries not only through ESAF, but also by stand-by arrangements which could be augmented to assist in financing debt reduction operations.

We note that market sentiment regarding the debt of developing countries has reversed somewhat and that the price of their debt has accordingly risen from the lows seen immediately following the increases in US interest rates in 1994 and the Mexican crisis toward that year-end. Nevertheless, countries relying on the private markets should be encouraged to resolve their commercial bank debt situation as quickly as possible.

With regard to the management of external debt, the heavy debt burden of many developing countries relative to their debt-servicing capacities makes this a major concern in the adjustment program of these countries. Increased borrowing by the private sector and public sector corporations could further add to the debt-service burden of these countries. We agree, therefore, that governments would need to take account of the overall debt situation in order to ensure that policy is not being derailed. At the same time, we would repeat our view expressed previously that the establishment of prudential general rules should, in most cases, be the adequate role for governments without the requirement for provision of any specific authorizations.

Finally, we would emphasize that addressing the debt problem is of great importance in developing sustainable medium-term programs, particularly for the heavily indebted poor countries.

Mr. Guzmán-Calafell made the following statement:

Since the last Board discussion of private financing flows to developing countries and their debt situation, the process of commercial bank debt restructuring has continued to evolve satisfactorily. A number of developing nations, including some low income countries, have been able to conclude agreements with commercial creditors, and in general some of the market conditions that complicated bank debt negotiations in 1993 and 1994 have ameliorated.

Perhaps the main difficulties in this area in the near future are related to the prospects for negotiation of the indebtedness of low-income countries with private creditors. The persistence of relatively high secondary market prices, pre-Brady speculation, and the limited availability of financial assistance to support buy back operations are at this stage the main obstacles to further progress in the restructuring of low income countries' commercial debt. On the other hand, it is clear that the latter would be unattainable in a number of cases in the absence of a strong cooperative attitude of commercial banks to accept conditions suitable to these countries' needs.

As noted by the staff, substantial resources from multilateral institutions will be needed to meet the financing requirements for possible Brady-type operations in the future. In the specific case of the Fund, it is suggested to provide this assistance through augmented small stand-by arrangements, taking due account of the country's debt servicing capacity. I do not oppose to this proposal, but I wonder if it is likely to have in practice any significant effect, given that in many of these countries non-concessional resources are of little use.

The most important development in private market financing to developing countries in 1994 and the first semester of 1995 is related to the sharp fall in bond placements by these countries, particularly those in the Western Hemisphere, that followed the increase in US interest rates first, and the crisis in Mexico later on. I agree in general with the staff analysis on the reasons for the strong correlation of returns on LDC's securities during periods of stress, and on the additional importance that potential contagion effects give to the implementation of sound macroeconomic and structural policies .

The speed with which access to international capital markets has been regained by a number of LDC's in the aftermath of the Mexican crisis is noteworthy. The significant recovery observed during 1995 in secondary market prices of debt and in stock exchange indexes are also surprising. The staff links these developments mainly to strong adjustment efforts in these countries and a more favorable external environment. I believe that the deep structural transformation that several of these economies have undergone over the last decade is another important explanatory factor. The rapid return to international capital markets, which is in sharp contrast with developments observed in the wake of the debt crisis in the early 80's, suggests that many investors perceive the current difficulties to be transitory and are in general optimistic about the medium and long term perspectives of these nations.

In closing my remarks on private market financing to LDC's, I want to note that my Mexican authorities have a number of comments on issues related to Mexico. These will be discussed bilaterally with the staff.

With respect to the papers on official financing for developing countries, I agree that some of the assumptions made in the analysis of the external debt sustainability for the heavily indebted poor countries appear to be optimistic. In fact, I would ask the staff how likely it is for the countries considered in the exercises to enter into stock of debt operations under Naples terms in the first place, since this might also proof to be an optimistic assumption.

The medium term outlook for a number of heavily indebted poor countries is worrisome. The staff analysis for 14 selected low-income rescheduling countries shows that even if these countries are granted a stock-of-debt operation on Naples terms and they adopt continued strong adjustment efforts, debt sustainability is not viable in some cases and highly vulnerable to the behavior of export growth and interest rates, in others. Furthermore, other heavily indebted poor countries are not eligible for Naples terms, and as the staff notes some of these countries face extremely heavy debt burdens.

Debtor countries have no option but to strengthen adjustment efforts. On the other hand, creditor countries will need to improve in some cases previous concessional reschedulings and to increase flows of concessional assistance. In this context, the decline in 1994 of Official Development Finance as a share of DAC countries' GNP to the lowest level since 1973 is disappointing.The staff proposes to consider whether, as circumstances evolve and adjustment continues, debt problems of those countries facing the most acute problems will need to be addressed in a concerted way. It would be interesting to have a clearer picture of the staff's ideas in this connection.

To conclude, I want to make two final comments:

First, in view of the different characteristics of heavily indebted poor countries, their different needs, and the high degree of uncertainty &that surrounds projections of the evolution of their economies, I fully agree that the preparation of detailed country specific analysis of the sustainability of total and multilateral debt service would be very useful.

Second, I missed in the staff's analysis of the indicators of debt sustainability a reference to economic growth. It must be taken into consideration that the achievement of debt service ratios considered to be adequate at the expense of low rates of economic growth will not be sustainable.

Mrs. Guti made the following statement:

The staff papers represent a major step forward in documenting and analyzing the debt problem facing developing countries, providing a consistent rationale for making the concept of debt sustainability an integral part of the policy dialogue regarding the adjustment effort in heavily indebted developing countries. The basic issue is that despite the positive developments aimed at containing the debt crisis, the problem is far from being over for many developing countries.

There are two other important facts that put our discussion in perspective: One is that it is the poorer countries that are most affected by the debt burden. The other is that African countries make up the overwhelming majority of these countries. Thirty three of the 41 heavily indebted low-income countries mentioned in SM/95/224 are in Africa, and the recent World Economic Outlook study shows that the debt burden, as a percent of export earnings, exceeds 400 percent in much of sub-Saharan Africa, despite attempts at debt relief in the context of adjustment programs supported by the Fund and the World Bank. The region largely depends on official bilateral lending, the fastest growing portion of developing countries' debt. Some of the countries are also beginning to experience a heavy multilateral debt burden. In the circumstances, it is not difficult to conclude that the mapping of a successful adjustment strategy for African countries must include modalities aimed at reducing the stock of debt to sustainable levels.

One of the major lessons drawn from the staff's analysis is that there is little prospect that most heavily indebted developing countries can exit from the rescheduling process in the absence of a comprehensive approach to dealing with the debt problem. This comprehensive approach must include significant stock-of-debt operations supported by improved terms by other official bilateral and private creditors. In addition, the donor community has to continue to provide adequate and timely concessional financing to help support the adjustment efforts in these countries. Also, the international community, including the Fund, needs to take a serious look at helping those countries for which multilateral debt is becoming a major problem. In this connection, it is important that multilateral financing be provided on concessional terms to help alleviate the debt burden over time. This is one of the reasons why the continuation of ESAF is important. In addition, due consideration should be given to schemes that enable the writing off of the debt of the poorest countries.

The analysis of the fiscal burden of external debt drives home the severity of the problem more so than the traditional debt-service ratio. It is noted that about half of the countries included in the study face debt-service payments on public sector debt exceeding one half of government revenue, and scheduled debt service exceeds total government revenue for more than one quarter of the countries. Seen in this light, it is clear that these countries have no way of avoiding the build up of arrears.

The hypothetical stock-of-debt operations for low-income rescheduling countries highlights the potential benefits of the Naples terms. However, these terms will not be sufficient to produce a sustainable situation in all countries. Even for those countries where there is potential for sustainability, one has to keep in mind the sensitivity of the outcome to key assumptions made by the staff regarding export growth and the terms of new financing. If exports were lower by just 1 percent or if external finance were provided at interest rates on average 1 percent per annum higher, the situation would deteriorate dramatically. This is particularly relevant to African countries whose vulnerability to terms of trade shocks is a major problem because of their undiversified export base. We are left to conclude that not only must the heavily indebted countries persevere with economic reform, but the international community should be prepared to assist them with adequate financing on concessional terms.

Let me conclude with a few comments on commercial debt and private market financing. Notwithstanding some successful cases of debt buyback operations, many countries find it difficult to conclude such operations, even at very steep discount rates, in the absence of sufficient external financial assistance. It is important for the international community to mobilize the necessary resources to support debt buyback operations as a means of providing a lasting solution to the problem. With regard to the proposal made by the staff to provide Fund assistance through a stand-by arrangement augmentation in conjunction with an ESAF arrangement, it would seem that the cost of such assistance might not be suitable to the payment capacity of the countries concerned.

On private market financing in developing countries, we agree with most of the analysis and recommendations made by the staff. In particular, it is worth emphasizing that the best guarantee against the volatility of the capital markets is for countries to pursue credible macroeconomic and structural policies and strengthen the operations of the domestic financial system. Regarding external debt management, I note the view of the staff that in some cases, and as a temporary measure, restraining foreign borrowing by the private sector may prove to be useful for the conduct of monetary policy.

Mr. Schoenberg made the following statement:

I would like to comment separately on the two issues of official and private financing for developing countries.

First, official financing: We agree to a very large extent with the thrust of the staff paper on official financing for developing countries and their debt situation. We fully support staff's assessment that the current mechanisms for official debt rescheduling are sufficiently powerful to handle the debt situation of most heavily indebted poor countries. Only for a very few single cases the current instruments will probably not suffice to solve their debt problems. There is, however, no cause for a major new initiative or a general shift in policies. The unfortunate fact that some countries with large arrears to the Fund are not yet eligible for Naples-Terms reschedulings from Paris Club creditors and that in the large protracted arrears cases settlement does not appear to be in early prospect is neither new nor surprising. We cannot, however, agree to the notion that those countries with relatively high total debt service burdens will be able to rely on new inflows, including from multilateral as, on appropriately concessional terms. The Fund as a monetary institution cannot treat its membership unequally by devising a debt-oriented strategy for some or by supplying financing over and above the terms applicable in the Brady-Initiative to date. In contrast, we want to stress the pivotal role the IMF has to play in the debt issues through its surveillance and its catalyst function. I would also like to make the point that in principle, any finding that the limits of indebtedness vis-à-vis the Fund have been reached would need to have as the consequence for the Fund to discontinue further lending. For a monetary institution, the consequence cannot be to switch toward concessional lending. That would be a sure way to provoke what we want to avoid in terms of moral hazard risks and the preferred creditor status of the Fund. The Fund cannot substitute for the decline in ODA or the uncertain IDA-prospects.

The issues contained in the staff paper on official financing for developing countries and their debt situation are much more relevant for the development banks and, of course, bilateral creditors, than for the Fund. Among the multilateral institutions, the Fund also has a different role to play than the development banks. We would appreciate it if this distinction would be made clearer throughout the whole paper. Table 3 on page 9 of the document, for instance, does not distinguish lending between the Fund and the development banks. It would help to sharpen the focus of this Board in our case-by-case deliberations to know exactly how big the Fund's involvement is and to help us find solutions which are compatible with a monetary institution. In reference to the World Bank's multilateral debt initiative leaked to the press yesterday, we confirm our position that it is not possible for the Fund to be part of any rescheduling of obligations toward the Fund. And concerning the Chairman's earlier remarks on the perception of the public on the role of the IMF and World Bank in that matter we would have no objection if the different roles of the two institutions are made as clear as possible to the public.

Last, we can agree to have these documents published, if confidential information has been deleted.

Second, private market financing:

My authorities were very pleased with the instructive staff documents, especially the background paper. We welcome the further progress that has been made in resolving remaining debt problems with commercial banks and agree with staff's assessment that current market conditions may provide a favorable opportunity for countries to make considerable progress in negotiations with their bank creditors, since price increases on the secondary market, especially for countries with successful stabilization efforts, may increase the cost of future reschedulings. We have some doubts, however, that staff's proposals of supporting Brady-type solutions for ESAF debtors through a specifically tailored stand-by arrangement is covered by current Fund guidelines. Maybe staff could comment on this. In any case, we will have to conduct a strict case-by-case analysis to make sure that Fund guidelines are respected and Fund support is appropriate.

We fully support staff's views that the best defense volatile private capital inflows and contagion effects from external shocks is sound economic policy, coupled with efficient management of external debt, including supervision of the private sector. We also agree that capital restrictions generally will not be able to contribute effectively to these ends. Adequate supervision of the banking sector and strengthened self-control of markets by increased transparency are important steps to ensure that full benefits may be reaped from private financing. Public debt management should also strive to lengthen the maturity structure of outstanding debt as soon as markets give leeway in that direction.

I believe it is not necessary to stress here that we tend to disagree with the staff' assessment of the Mexican crisis in the papers before us. I do not wish to respect the discussion on that issue. I would like to mention, however, that in this connection, we found the comments on recent bond reschedulings contained in the background paper especially interesting. We would have welcomed it if this aspect had found its way into the main document. If the Tesobonos had been handled in a similar fashion than for instance outstanding debt by Costa Rica, Guatemala, Nigeria and Panama, a moratorium might also have been avoided, even without massive IMF support. So, we would have welcomed a more differentiated analysis on the Mexico case in comparison with the other bond reschedulings in the background paper. With the benefit of hindsight and, therefore, as a matter may be considered in potential future case it is also interesting to observe that the notion is gaining increased attention in the U.S.A. that holders of Tesobonos should have been requested to reinvest their interest income in Peso-denominated bonds. Since the high interest rates for Tesobonos of 25 to 30 percent clearly included a substantial default risk premium, such a request would have been understood and accepted by markets.

In this connection, we are somewhat worried about the potential reliance of many creditors on a bailout by the international community. New debt issues of Argentina, Brazil, and Mexico, for instance, only have a spread of 3-4 percentage points above some of the highest rated industrial countries. Considering the substantial economic and, to a lesser extent, political problems of these countries, this fact is some what amazing. Maybe staff could comment whether this could be explained by belief in an international bailout by private creditors.

Mr. Leiva made the following statement:

I would like to join other Directors in commending the staff for the very clear and useful papers on financing for developing countries. I will start by commenting on issues related to private market financing.

During 1994, the sustainability of substantial private capital inflows for developing countries was twice tested, reassuring that market access for developing country securities can be maintained.

Early last year, the tightening of monetary policy in the United States precipitated turbulence in international capital markets, affecting net capital flows to developing countries. In the second half of 1994, however, new bond and equity issues picked up sharply. The Mexican crisis, later in December, was a second test for the resilience of net capital flows to developing countries. Yet, disruptions arising from this crisis during the first trimester of 1995 were replaced by renewed interest in developing country securities by foreign investors since March.

After the turbulences of these two events have passed, the strength of the general trend toward globalization of financial markets and diversification of investor's portfolios has been confirmed. Even after their decline from the peak of 1993, the flows to developing countries have been substantial enough to remain a key element in their economic expansion.

For the countries with access to these flows, their volatility has become a potential threat to macroeconomic stability. The magnitude and the speed of the swings of capital inflows are not in proportion to the size of the recipient economies. We share the staff's analysis on the factors that may have contributed to establishing conditions conducive to producing higher volatility: the expanding presence of institutional and other investors with similar characteristics and risk/return preferences; and the identification of developing country securities as distinct asset class by institutional investors.

Higher volatility and its impact on macroeconomic behavior is still another reason to stress the need for strengthening debt management and the prudential, regulatory and supervisory framework of developing country financial markets (including banks and security markets).

Moreover, countries that are participating and taking advantage in the globalization of financial markets need to implement a broader effort to reduce risks of macroeconomic instability than the one which is usually implied in debt management. A strategy with respect to the structure of capital inflows is called for. The two main goals of this strategy should be increase: the share of non-debt creating flows, and the maturity of the debt obligations.

For the countries that are not benefiting from significant net inflows, participation in international capital markets has become extremely attractive. The developments of 1994-95, have clarified the conditions for obtaining access to these markets. In addition to solving official and commercial debt problems, implementing appropriate macroeconomic policies and structural reforms to create investment opportunities are unavoidable requirements for the participation in world capital flows.

To conclude my remarks on private market financing, I wish to highlight that the economic distinction between domestic and international debt issues seems less compelling in today's globalized and integrated financial markets with capital account convertibility in many countries. The changing conceptual implications of this distinction might be usefully revisited in the future.

In addition, these developments in international financial markets call for an enhancement of the databases used in the Fund assessments. The Fund should aim at capturing in a more comprehensive manner all the international offerings of private borrowers from those countries with market access.

If the papers on private market financing are to be published, which I would favor, appropriate updating of some tables and country specific references would be desirable to ensure that the latest trends are fully reflected.

Turning to issues related to official financing for developing countries, I would like to refer to this chair's concern, in our last discussion on "Bilateral and multilateral aid flows", that the declining trend in official development assistance would have an important impact on low-income countries, being unlikely that this expected decrease will be offset by an increasing concessional financing from multilateral agencies.

Official bilateral debt remains, however, the fastest growing portion of developing countries' debt. In this regard, the implementation under Naples terms of debt rescheduling by Paris Club creditor countries for low-income countries constitutes a major step toward easing the debt situation of these countries.

Nevertheless, the prospects for the achievement of overall external debt sustainability and an exit from the rescheduling process for the majority of low-income depend on two key assumptions: the continuation of aid flows, and comparable treatment by non-Paris Club official bilateral creditors and private creditors. Furthermore, a durable exit from the rescheduling process would require that creditor countries be prepared in some cases to top up previous concessional reschedulings. In this regard, I would like to point out that within the Western Hemisphere non-traditional creditors have afforded significant concessionality in rescheduling debts of the countries in the region.

I share the staff view that current Naples terms appear to be insufficient to achieve debt sustainability for a number of low-income countries, because of their weak external positions and that a concerted effort among debtors, creditors and international institutions is needed.

I join other Directors in urging the staff to develop approaches to deal comprehensively with the debt problem in low-income countries in cooperation with other institutions involved in multilateral as well as bilateral financing. Propositions made today, by Mr. Mirakhor for instance, are precisely the kind of approach to be studied and evaluated to progress toward substantive solutions in this area.

Mr. Havrylyshyn made the following statement:

We would like to express our appreciation for the staff's ongoing analysis of the debt situation of developing countries with which we broadly agree. Although, as the staff rightly points out, the analysis is still partial and the findings are still preliminary (and so too is the discussion here), we feel that the work is moving in the right direction. It is particularly welcome that issues, which until now had received little attention such as the fiscal burden of external debt, are coming into the picture.

Let me start by borrowing from the very constructive statement of Ms. Lissakers, taking what I think is the axiomatic core of the Fund's role, i.e.

"The Fund will need to play a central role in (this) effort given its responsibilities for promoting sound policies--which are the ultimate solution." (my emphasis)

The promotion of sound policies, reflecting the monetary character of the Fund must remain the axiomatic starting point in any strategy developed for dealing with the heavily indebted countries. It should be, as always, the first and main role of the Fund. But this does not mean the Fund would be closed or inflexible to new initiatives of the international financial community, or to cooperating on such initiatives. Nor does it mean the Fund takes the view that sound economic policies are sufficient to resolve this very large problem.

This axiom of sound policy also has something to say about the degree of optimism or realism of the Naples Terms baseline scenario. I do not find it easy to assess the various assumptions of the Staff paper's projections. But it does seem to be eminently reasonable to assume that the countries themselves undertaking a sound-policy adjustment program is part of the

Naples Terms. In fact, if they do not, I for one cannot imagine any innovative, ingenious package that will help. With Staff's further explanation this morning--and your comments--I don't have any strong reason to doubt the other assumptions on reduced bilateral aid flow and PFP- based export projections and therefore can accept the conclusion that for most of the heavily indebted low income countries the present baseline scenario of Naples Terms approach provides in principle sufficient debt relief to achieve a sustainable debt situation, if adequately implemented by both the debtor and creditor side. Messrs. Kaeser-Keller give us a useful description of the baseline scenario: "the prerequisites and conditions for the countries possible exit from the rescheduling process." I think Staff might agree that these conditions are a good definitive of the huge magnitude of the problem.

But this does not preclude the logical possibility that additional approaches can promise an even better and faster resolution to the problem. Nor, is a successful implementation of the Naples scenario for the 14 or 27 enough. As the staff's analysis shows, for a number of heavily indebted low-income countries current Naples terms would appear insufficient. It remains obvious that most of the heavily indebted low-income countries will continue to be dependent on aid inflows for a long period of time. In some cases higher debt reduction by the Paris Club would appear necessary. In the limited cases the problem is caused by the relatively high multilateral debt service obligations, lending should be better tailored to their long term repayment capacity. I note on most of these cases parallel relief-measures for bilateral and commercial creditors would also be essential. Additional approaches building upon a Naples base-scenario will be necessary, the staff suggests some, some Directors today have added others, and I expect more will come.

Under the current Articles of Agreement, the Trust Fund cannot be used to provide concessional resources in order to finance Brady-type debt and debt service reduction operations. The staff suggests that the Fund could support debt operations for low-income developing countries under its current guidelines through the provision of a small stand-by arrangement, to be augmented in support of the operation, in conjunction with an ESAF arrangement. We have some concerns about this approach. Providing nonconsessional resources to the severely indebted low-income countries eligible for ESAF seems undesirable, and could result in unsustainable multilateral debt service profiles in the medium term, thereby only shifting the problem to the future. As a second best, it may be acceptable to consider, as Mr. Clark suggests, on a case by case basis, but more important will be the need to find ways to finance an interim ESAF.

A case by case approach seems warranted for the small and heterogenous group of countries with protracted arrears. It is unlikely that the three countries that are still eligible for a rights program, will be in the position to benefit before April 1996, when the extension expires. Moreover, even if these countries could settle their arrears through the rights approach, they would face extremely high debt-profiles. We agree that clearance of arrears should be funded in ways that reduce the risk of future problems.

With interest we have taken note of the staff analysis on the correlations in developing countries securities markets. Experience of Asian countries has shown that countries implementing sound macroeconomic and structural policy programs, are strong enough to withstand a sudden change in sentiment of emerging markets. Most other developing countries are not in this position yet. In our view, the Staff seems prematurely optimistic in concluding that 'continued strong performance by a number of countries and the determined adjustment efforts of those that have encountered difficulties, accompanied by timely assistance provided by the Fund in key cases, appear at this juncture to have sustained investor interest in developing country securities'. We agree that the liquidity package for Mexico provided by the international community has served its goal and ensured access of developing countries to capital markets. However, in most countries that encountered difficulties fundamentals have not yet changed. Only with continued strong adjustment measures will these countries become less vulnerable to market sentiment. Thus, at this juncture we should not jump to conclusions but keep a close eye on developments, in particular given the possibilities of future increases in long-term U.S. interest rates.

A last point on private investors selectivity, which Staff rightly notes is not only important, but gratefully increasing as they learn more about specific emerging markets. Of course, a crucial part of this learning process on the part of investors, is information. It could therefore be safely presumed that in order to help institutional investors to speed up and refine this asset differentiation process, developing countries should make every effort to make available as much information as possible, and in a timely matter. This strategy would reduce the risk of being vulnerable to exogenous shocks, as it would highlight the fundamentals. This, once again, stresses the importance of openness and transparency. In that spirit, I think it is not only acceptable to publish these papers as usual--with appropriate editing and timing--I think it is important to do so. Not doing so could raise questions amongst those who are expecting their annual copy and call forth unwelcome doubts.

Mr. Kiekens made the following statement:

Let me start by commending the staff for their excellent papers on official and private financing for developing countries. The intriguing findings of the reports and the background paper will be of great value to government agencies, the academic community, and the private sector. I would therefore like to express my support of the proposal for their publication with the omission of certain sensitive information. However, I agree with your suggestion that it is important to be attentive to the timing of the publication. Let me stress that, if divergent viewpoints prove to exist between the Fund and the World Bank on these matters, which is unfounded at this time, as you pointed out at the beginning of this meeting, that should not prevent the Fund from publishing its own position, especially if the World Bank is doing the same thing. The diverging positions, if any, would most likely turn out to be attributable to the different natures of the two institutions.

On the issue of Official Financing, let me first note that the bulk of official financing is owed to bilateral creditors and that a solution of the debt problem of the heavily indebted countries is in the first instance to be sought from an improvement of bilateral credit terms. In this connection, I note that the Paris Club's Naples terms have been widely accepted and have brought about some improvements in the external debt situation of the developing countries, with 11 successful reschedulings having taken place so far. But it is doubtful that even the added generosity of the Naples terms will do much to brighten the future for the poorest countries or enable them to graduate from the Paris Club's rescheduling process. For these countries, more decisive and far-reaching measures are needed. The staff's projections of the effect of a hypothetical stock-of-debt operation on the 27 low-income countries that are eligible for Naples terms provide grounds for cautious optimism. The presence of a good-will clause and the fact that 17 of these 27 countries are already implementing programs with the Fund gives reason to believe that these highly desirable stock-of-debt operations will become a reality sooner rather than later.

Although unchanged in absolute volume, the composition of multilateral financing has improved for the heavily indebted countries: the past decade has seen a dramatic increase in the share of concessional debt. It is hard to overestimate the importance of the Fund's ESAF for the heavily indebted developing countries. I believe that the paper once more demonstrates that the Fund's general policies to support the poorest members are appropriate and, like Mr. Mesaki and others, that ESAF should remain the centerpiece of the Fund's support of the poorest countries. We must therefore continue working on a solution for its future financing.

I share the staff's view that in assessing the sustainability of external debt service, we must take account of the terms of new borrowings, the sensitivity to changes in assumptions on exports and new inflows, the implications of external finance for growth, and the fiscal implications of external debt. This requires that the debt issue be addressed on a case-by-case basis, which will be more effective than trying to find unrealistic broad solutions.

The absence of a creditor's club for certain FSU countries forced the staff to invest considerable effort into obtaining financial assurances from a number of creditors, negotiations which in some cases required a great deal of diplomacy and patience. The donors' and creditors' meetings organized by the Fund staff for Armenia, Georgia, and Tajikistan could, with the addition of an appropriate organizational framework, evolve over the medium term into some sort of creditors' club for the heavily indebted transition countries, an idea which was first brought up some time ago.

On Private Financing, I would like to make the following brief comments. The findings of the staff papers once more confirm the correctness of the more optimistic of the views expressed when the Mexican crisis erupted. In accordance with the basic expectations, there were spillover effects that depressed a large number of developing country markets with a sizeable jump in sell orders. But this example of herd instinct on the part of investors was overcome in an impressively short time by those countries' implementing, in a consistent and unswerving manner, corrective macroeconomic and structural reform programs. The emerging markets generally have satisfactorily passed the maturity test posed by the Mexican crisis and managed to preserve their access to the world financial markets. This also demonstrates that what counts with the markets is sound macroeconomic fundamentals, or policies appropriate for correcting the imbalances. The indebtedness problem is only one of these fundamental imbalances that impair countries' market access. Countries with high debt burdens which manage to overcome the short-term crisis rapidly are enabled to do so by the soundness of their policies. I nonetheless recognize that the management of debt should receive higher a priority in the policy agendas of every member country, especially in terms of closer attention to maturity structure and currency composition. There, like other speakers, I insist that these issues be more systematically discussed during the Fund's consultations with its member.

The first six months of 1995 were marked by considerable progress toward resolving the commercial bank debt problems of the developing countries. The staff paper indicates that nine more countries are nearing conclusion of their debt deals.

The current decline in the secondary market prices of developing countries' bank claims, ironically a favorable result of the Mexican crisis, should be used by developing countries to achieve improvements in the terms and structure of their outstanding debt. I would like to join the staff in encouraging the developing countries to seize this opportunity without delay.

Ms. Lissakers said that she was concerned that some Directors, including Mr. Kiekens, had emphasized the need for a case-by-case approach for solving external debt problems. She wondered whether Mr. Kiekens considered the Brady Plan, which had provided a new framework for addressing the problems of individual debtors, a case-by-case or a comprehensive approach. The Board, the Interim Committee, and the Development Committee should decide whether a new framework for addressing the multilateral debt problem was needed. A comprehensive approach was not incompatible with a case-by-case approach.

Mr. Kiekens replied that the case-by-case approach could be part of a more general framework that addressed the debt problem.

Mr. Koissy made the following statement:

As a consequence of their past borrowing activities, developing countries are presently faced with external debt service obligations which are very large in comparison to their export earnings. Debt service charges are taking away scarce resources which could be used to cover the cost of development projects urgently needed to promote economic growth and broaden as well as diversify their export bases.

Debt service difficulties have led, in some cases, to an accumulation of arrears on bilateral debt, and at times with multilateral institutions. Reflecting these difficulties, many countries have been requesting debt rescheduling and debt cancellation schemes and have become heavily dependent on concessional official resources from both bilateral and multilateral sources. Many countries which have previously used private financing are now also involved in debt renegotiations with commercial banks. Only emerging market countries appear to have been successful in attracting private capital to continue to finance direct investment. It is against this background that today's discussion has to be seen.

The papers prepared by the staff provide useful information on the recent trends in the flows of official financial resources to the developing countries. They also draw our attention to the access of developing countries to private market financing, the sustainability of the developing countries' external debt, and recent rescheduling practices by members of the Paris Club under the Naples terms.

Turning to some of the issues for discussion: as regards the "Naples terms" of debt treatment, we share the assessment of the staff that they represent an important step in the search for a lasting solution to the international debt problem. Nevertheless, we note that for many low income countries, current Naples term would be insufficient to achieve debt sustainability. However, in order to be more effective the implementation of "Naples terms" at the Paris Club will have to be accompanied by similar treatment of debt by other bilateral donors and by private creditors. While we are convinced that "stock-of-debt operations "will create favorable conditions for many countries to exit from the process of debt reschedulings, it is not certain that the current mechanisms are sufficient to solve the debt servicing difficulties of many countries, especially those whose debt is mainly vis-à-vis multilateral institutions. For these countries, it is possible that they will continue to face relatively high total debt-service charges, after Paris Club stock-of-debt operations have been carried out.

Here, there are two main points to be made. First, there is the possibility, to help these countries to continue to receive "fresh money" from multilateral institutions in order to cover their debt service obligations. Although these resources will be obtained on concessional terms, they will not really contribute to a lasting solution of the debt problem facing the heavily indebted countries, because they will only serve to finance their debt obligations falling due. This brings us to the second point which is the need to review the current treatment of multilateral debt.

In this regard, we regret that the staff papers have not looked into ways to address this problem, in view of the fact that financial obligations of some member countries to the Fund represent a large share of their multilateral debt. We therefore, support Mrs. Lissakers' suggestion to urge the staff to cooperate closely with the World Bank in developing a comprehensive approach to the multilateral debt burden of the low-income countries. In this context, recent press reports regarding a World Bank task force on this issue appears to be interesting and we wonder if the staff could give us more details on it.

As regards private market financing for developing countries, we note that over the past year, significant progress has been made in resolving the commercial bank debt problems of a number of developing countries. However, we are concerned by the fact that private market financing for developing countries also declined in 1994 from the level of the preceding year.

We believe that the more active role of the private sector and autonomous public sector corporations could help to mobilize resources from private international capital markets. This can only take place if the countries concerned have been successful in implementing structural reforms in order to improve the performance of domestic enterprises and make them more competitive vis-à-vis foreign firms.

Finally, we note with serious concern, that net official development assistance (ODA), which represents a large share of total development assistance from official sources, has been on a downward trend in recent years. It is even more worrisome to learn that this declining trend is expected to continue in the foreseeable future, because of budgetary constraints in most donor countries.

We believe that in the search for a lasting solution to the debt problem of low-income countries, the international community, in particular multilateral institutions have a major role to play. In that context, a more imaginative approach is needed which will have to move away from the current practices of successive debt reschedulings, focusing primarily on the need to reduce existing stock of debt.

Mr. Autheman made the following statement:

As usual, I found this set of papers excellent and I support their publication. I think that we should be cautious about extending our disclosure policy, but that we should not consider any reversal in our traditional openness. These papers provide very useful information for country officials, markets, academics; and we should not deprive them, at a time when there is growing interest for this issue, of the pleasure to read the work of the Fund staff.

I have a few comments on the paper relative to private flows. First, I welcome Mr. Schoenberg's comments on the paragraph in the background paper dealing with bond rescheduling. This, as he says, sheds an interesting light on our way of dealing with Mexico. I guess that it would not have been the proper route to follow at the outset, but I continue to think that, during the implementation of a program--as I said at the first review of Mexico--we should have shown more interest for this approach. So, I would welcome some reflection of this background paper in the main document.

Second, I would like to echo the recommendation made by the staff in the second issue for discussion. We share the concern that some debtor countries, which now meet the condition for normalizing their relationship with commercial bank creditors, appear tempted to delay these negotiations under the false expectation that this would improve the terms they would receive, while it could only slow the country's return to a credible international position. I am making this point, because I forgot to make it yesterday in a specific case.

Third, in paragraph 3, which is the issue of Fund's the involvement in debt and debt-service reduction operations for ESAF-eligible countries, I sit closer to Mr. Clark than to Ms. Lissakers and Mr. Evans. I think we cannot afford to finance such operation with ESAF. I would like it if we were able to, but I think that ESAF is too rare a resource to be used for financing the guarantees required by these operations.

Turning to official debt, I share Mr. Kaeser's view that one of the most important recent developments--and I would say the most important one--has been the agreement on the Naples Terms, which I see as the comprehensive solution we are looking for. I know that between Naples and Lyon there was Halifax, but Halifax should not lead us to forget Naples. Mr. Lanciotti may be more convincing than I on that point. The analysis in the background paper, pages 55-89, which Mr. Kiekens already referred to, on the potential impact of stock of debt reduction, shows in a convincing way that the Naples terms represent a decisive breakthrough, as the staff says, and that, for most countries, the current mechanisms are sufficiently powerful to handle their heavy debt burdens, if they follow the right policies. We should not contribute to a negative advertising of such a breakthrough.

I share the staff's conclusion that most heavily indebted poor countries, after a stock of debt reduction, will be able to manage their position. I agree that specific limited problems will remain in countries such as Nicaragua, Mozambique, or Zambia, which have followed a very peculiar path, which has no general character. I would also point that countries which fail to implement proper policies will not be able to address their debt burden situation. Messrs. Clark and Evans pointed that, after the four cases identified by the staff, there were ten others. I do not think that we need to develop a policy for countries which have not achieved a solid policy track record, other than trying to convince them to change their policies. Otherwise, we would risk a moral hazard by being ready to provide support to countries which do not engage in the right policies.

I also think that we should consider some tightening of our conditionality. We may be too willing to finance permanently high current account deficits, and we may be too willing to finance countries with unacceptably low fiscal revenue performance. On this second point, I share Ms. Lissakers's positive reaction to the staff's background paper relative to the fiscal cost of the debt burden. In many cases, the fiscal cost is unsustainable because countries do not implement strong policies to increase revenue performance, which remains at an unacceptably low level.

But the main issue is that highly indebted poor countries are countries which we expect will maintain a high current account deficit; let me quote one example. In Uganda, on average, between 1994 and 2002, the staff expects that debt service would represent 24 percent of exports of goods and services, but that current account deficit would represent 51 percent of exports of goods and services. So, let us not identify a debt issue where there is a current account issue, and let us not identify a Fund debt issue, since debt service vis-à-vis the Fund is usually very low, 8 percent of exports of goods and services, in the case of Uganda.

The problem is that the poorest countries are not expected to reach sustainable current account positions in the future, even when they implement good policies. As a related consequence, the debt position of these poor countries may become unsustainable not only if they fail to implement proper policy but if the international community fails to maintain its support. It is quite striking that countries which are engaged in a sharp reduction of their aid budget are the ones who are insistent on the issue of multilateral debt; and countries which are ready to maintain their aid effort are more optimistic.

Mr. Clark is calling for a comprehensive solution and Ms. Lissakers for a new framework, which implies that Naples is not a comprehensive solution, which I challenge. I think we should beware of not telling our taxpayers that we are providing support to something useless.

But what is this new framework? Mr. Mirakhor has offered some views, but could other colleagues explicit their private thoughts so that we can discuss what this new framework would be? Another way to put it is: where would the new money come from? Mr. Evans, who is an expert both on the issue and of the relative quality of English-speaking press, invited to us pay attention to The Economist. May I quote an extract from the paper published today: "Would it--it being the so-called World Bank new framework--attract more government money than would otherwise be forthcoming?" I think that it would be helpful if Ms. Lissakers, Mr. Evans, and Mr. Clark could answer this question. I have the feeling that our debate would be less difficult.

Finally, I think that Mr. Allen was right in our February 24 meeting when he concluded his statement with the following "message": some of the poorest countries cannot continue to finance themselves from multilaterals unless this is done on a concessional footing. I continue to agree with it. I am not worried by the so-called multilateral debt problem. On the contrary, I am extremely worried by the prospects of IDA negotiations.

Mr. Evans considered that Mr. Autheman had underestimated the problem of multilateral debt. In 1994, when Mr. Smee, Mr. Clark's predecessor, had pointed out that multilateral debt was indeed a problem, there had not been much support in the Board for his views. However, over the previous 12 months, many Directors had realized that, even after debt rescheduling on Naples terms, several countries continued to face debt problems. As this was not limited to three or four countries, it would be helpful to have a clear view of the magnitude and the seriousness of the debt problem, and the number of countries affected.

The Chairman said the Mr. Autheman had posed an important question regarding the sources of the additional concessional resources required to solve the debt problems of heavily indebted poor countries.

Mr. Evans replied that the Fund should investigate the possibilities of finding the resources necessary for financing the continuation of ESAF on more concessional terms. Resources could be raised by enhancing the use of existing reserves, and through reinvestment of proceeds from limited gold sales.

Ms. Lissakers said that Mr. Autheman had pointed out that the heavily indebted poor countries would not achieve self-sustaining current account positions in the near future. He had also emphasized the importance of strengthening the Government revenue base in dealing with the debt situation of a country. However, she had been puzzled by his statement that the Fund should design programs to make it easier for countries to move to sustainable current account positions. If a country could achieve a sustainable current account position, there would be no need for external financing from the Fund or other international institutions.

With regard to financing, the important question was whether it was rational to continue the ESAF which the Board was contemplating as a "solution" for good performers like Uganda, Ms. Lissakers continued. A higher proportion of the ESAF funds were being used for debt servicing. Until the inauguration of the Brady Plan, a similar "solution" had been pursued with respect to commercial debt.

Although the ESAF might turn out to be the lowest cost option both for the Fund and the member countries, it was not a viable instrument, Ms. Lissakers concluded. All international agencies needed to approach the multilateral debt problem in a more concerted manner, with a view to using scarce resources efficiently.

Mr. Autheman said that, within the following 6 to 12 months, the Fund would have to provide appropriate concessional financing to members to cover current account deficits arising from a probable shortfall in international aid flows. Therefore, too much time should not be wasted in discussing the IDA replenishment. In that context, the main problem was not the debt burden, but how the current account deficit could be reduced under conditions of declining aid.

Ms. Lissakers replied that the Board should consider the debt and the current account deficit problems as parts of a general adjustment problem.

Mr. Schoenberg considered that Mr. Autheman had raised an important issue with respect to the Fund's ability to compensate for the decline in official development assistance and for the uncertain prospects for an IDA replenishment. He was concerned that many Directors considered the establishment of a permanent ESAF as a viable solution to the financing problems faced by member countries since including debt relief under the ESAF might not be in accordance with the original purpose of the facility.

The Chairman said that the series of staff studies on the debt issue had clearly demonstrated that concessional lending from the Fund was indispensable to support the financing needs of a large part of the membership.

Mr. Schoenberg replied that a permanent ESAF might have some beneficial side effects for solving the debt problems of many developing countries. However, the main purpose of the ESAF was to facilitate medium-term structural adjustment.

The Chairman said that, without ESAF, it would be difficult to carry out medium-term structural adjustment programs in member countries. Under the circumstances, the continuation of the ESAF provided member countries with some incentive to persevere with difficult reforms. At the same time, it relieved the burden of sister organizations in providing financial resources to member countries.

Mr. Clark said that, in order to get a realistic picture of the magnitude of the debt problem among the membership, the ten countries that he had mentioned in his statement should be classified as severely indebted. If those ten countries agreed to adopt appropriate policies, they would be eligible for Fund assistance.

The Chairman noted that those ten countries needed to establish a credible track record in policy implementation, which would give the Fund time for developing and extending a framework to address their problems.

Mr. Lanciotti made the following statement:

> The high dependency of most developing countries on external financing (both official and private) for the achievement of external sustainability and enhanced prospects for future growth, and the role that multilateral institutions, such as the Fund, can play in this process, underscores the importance and urgency of

this discussion. The staff paper on official financing provides a very interesting simulation of the prospects for external-debt sustainability--following an hypothetical stock-of-debt operation on Naples terms from Paris-Club creditors--for a selected group of heavily indebted low income countries.

I agree with the staff's observation that current mechanisms are powerful enough to handle the heavy debt burden of most countries. The test made, on a sample of 27 countries, to assess their possibility of achieving sustainability, and thereby an exit from the rescheduling process, following a stock-of-debt operation under the above mentioned terms, shows that: prospects are good for two thirds of these countries, appear less secure for a group of four heavily-indebted countries, and are very limited for the remaining four countries. Even though this rather positive outcome supports the staff's observation, it is worth mentioning that these results must be interpreted with some caution for the following reasons.

First, even after the stock-of-debt operation, most countries will remain strongly dependent of aid inflows, meaning that even if debt sustainability can be achieved, external viability is still far in the future. Therefore, as the staff points out, greater concessional assistance will be needed in order to enhance the chances of a durable graduation from rescheduling.

Second, notwithstanding the fact that the above mentioned analysis was not extended to all heavily indebted countries, its conclusion relies on several assumptions, some of which require the effort and commitment of both creditors and indebted countries, and others which involve a certain degree of uncertainty. The assumptions that at least comparable treatment be provided by other official bilateral and private creditors, and that adjustment and aid inflows will continue, imply that a concerted action be undertaken to solve the debt problem. In addition, as these results are dependent on country-specific assumptions based on future export and GDP growth, they are subject to some risk, depending on the sensitivity of the analysis to changes in parameters, which is different among countries, and on the relative dimension and diversification of the export sector. These risks can be minimized if countries continue to pursue strong adjustment and structural reform policies aimed, in particular, at broadening and diversifying the export base.

Since the prospects for debt sustainability are not favorable for all countries, and given its importance for the establishment of normal trade relations and foreign investment flows, it is important that other mechanisms continue to be explored to face the debt problem in those countries in which the stock-of-debt operation was found insufficient or impossible, as some poor countries are not eligible for Naples terms. In order to allow those countries to realize their growth potential, external financing should remain available at concessional terms, as long as commitment to a strong adjustment program is evident. I share the staff's view that the analysis of sustainability should focus on country specific conditions such as, terms of new borrowing, sensitivity to changes in assumptions of exports and new inflows, implications of external finance for growth, and fiscal implications of external debt.

Given the need to safeguard Fund resources, I welcome the fact that the staff will explore possibilities for funding clearance of arrears in countries with large protracted arrears, which represent the heaviest potential burden of debt service to the Fund. However, the use of Fund resources for this purpose must be consistent with the monetary character of this institution and revolving character of its resources. This requires the maintenance of strong conditionality standards in extending traditional facilities and in any revision of the mechanisms for debt reduction operations. In this context, at this stage it is difficult to envisage any other approach to deal with debt outstanding to the Fund, beyond that, already available, under the Rights Accumulation Program. Given these limitations, dealing with cases of protracted arrears is strongly dependent on initiatives taken by other multilateral institutions, such as the World Bank with IDA-type resources.

Turning to the private financing of developing countries, let me first emphasize that I strongly share the staff's view that the existing menu approach to bank debt problems is proving effective and any further delay of indebted countries in normalizing their relations with commercial bank creditors is more likely to generate an increased build-up of arrears, rather than prompt better debt servicing terms in the future. Furthermore, it goes without saying that the delaying of the normalization of relationships with external creditors is a major impediment to the financing and implementation of economic adjustment programs.

As for the staff's suggestion that the Fund support debt reduction operations through the provision of small stand-by arrangements, augmented in support of such operations and in conjunction with ESAF financing, I think that the proposal is worth exploration. Of course, the successful conclusion of debt reduction operations requires the availability of adequate and coordinated resources from multilateral institutions and bilateral donors. Moreover, I share the concerns of those who stress the need for a careful case-by-case approach. Out of the context of a strong economic adjustment program and an improving balance of payments outlook, debt-reduction operations financed by the Fund at non-concessional terms could exacerbate the debt-servicing problem and merely cause the replacement of one creditor by another.

In conclusion, Mr. Chairman, turning back to the general problem of poorest countries' indebtedness, I think that it is to be recognized that for a small but non-negligible group of countries the stock-of-debt approach of the Naples Terms may not be sufficient to restore debt-service sustainability. For these countries, I agree that imaginative solutions, as Ms. Lissakers calls them, could be usefully pursued. On the other hand, I am also convinced that these solutions have to be found essentially in the domain of multilateral and bilateral development agencies, with the Fund playing, by "institutional necessity", a complementary, supporting role.

The Chairman said that he had understood that Mr. Lanciotti was arguing for more imaginative solutions to members' debt problems, with the direct involvement of bilateral and multilateral development institutions. In that framework, however, the Fund was expected to play only a supporting role, particularly in promoting sound policies.

Mr. Wei made the following statement:

I join the others in welcoming the annual discussions of the developing debt issues and the staff papers which I find very informative and useful. While it is encouraging to see the results of the staff preliminary analysis, which suggests that possible advances could be made in debt relief with the implementation of the Paris Club Naples terms, it is regrettable to note that presently net official development assistance stands at its lowest level since 1973, after a further decline of 2 percent in real terms in 1994. It should be pointed out that the reduction of ODA will inevitably have a negative impact on the adjustment efforts of many developing countries, especially the heavily indebted countries who have to rely mainly on the ODA for meeting their economic needs. I would like to join the others in urging industrialized countries to make sincere efforts in increasing ODA levels.

On the issue of the general debt situation of developing countries, while I am pleased for those developing countries making important progress in restructuring their commercial bank debts, I would like to reiterate our concerns over the seriousness of the general debt situation in the poorest developing countries since the debt burden has become one major impediment to their economic development. Continued and concerted efforts by the international community, particularly the considerable contributions of the major developed countries, are requested in order to realize any practical solution or substantial improvement to this problem.

We continue to believe official development finance should play an important role in increasing capital flows to developing countries, taking account of the objective of sustaining their economic growth, which contributes to the lasting growth of the global economy in an integrating world. For the heavily indebted poor countries, a durable graduation from rescheduling and necessary reserve build-up is inseparable from a substantial increase in highly concessional assistance. Fresh capital flows on reasonably concessional terms, including that from multilateral institutions, will be one of the key elements for attainment of a fundamental solution to the debt issue.

The increased concessionality associated with the income-level-based Naples Terms represents a step forward for stock of debt reduction. However, I would like to point out the need for effective action to be taken on the part of donor countries in order to accelerate the implementation process, which is of critical importance to developing countries. As noted by the staff, and I quote, 'It is of immediate concern that these countries receive sufficient concessional external finance to realize their economic growth potential in support of a sound program.'

In the case of Mexico, I share Mr. Shaalan's view that the Mexican experience "underscores the importance of the consistent implementation of sound macroeconomic policies in ensuring continued access to foreign capital on reasonable terms."

We continue to support efforts made by multinational institutions to play an appropriate role in alleviating the debt burden and support economic adjustment of developing countries. As we have indicated on other occasions, Fund ESAF should be made continuously available to heavily indebted developing countries for the purposes of BOP strengthening and structural adjustment. We are in favor of the proposal that the Fund support debt operations for the heavily-indebted countries under its current guidelines through the provision of a small stand-by arrangement, to be augmented in support of the debt and debt-service reduction operations, in conjunction with an ESAF arrangement. In this connection, I would like to encourage the Fund to work closely with the World Bank, as well as regional development banks, for a coordinated program directed at the external debt sustainability of all members concerned.

Finally, we would like to see an increasing role to be played by the Fund in providing finance and technical assistance to developing countries in assisting efforts to adjust the economy and improve their debt situation.

Mr. Kang made the following statement:

I wish to commend the staff for responding to the Board's request for a more comprehensive coverage of debt and the use of finer country groupings in the analysis of the magnitude and sustainability of the debt burdens of the heavily indebted poor countries. Albeit preliminary and partial as described by the staff themselves, I find that the analysis in the staff paper and today's discussion have been very useful in confirming the depth of difficulty which many of our member countries are encountering in tackling the debt problem. We also look forward to the extension of the analysis to individual country cases in the future.

Despite the qualifications cited by the staff, it is clear that a number of heavily indebted poor countries will continue to face debt-service difficulties in the medium term. Already, optimistic assumptions were used in terms of the restructuring at Naples Terms of the debt of eligible countries and the comparable treatment of private and non-Paris Club debt, as well as the continuing net inflow of capital on concessional terms.

I concur in particular with Mr. Clark's concluding suggestions that the Fund must work with other multilateral financial institutions to develop comprehensive solutions to the debt problem. Assistance through the joint preparation of PFPs and credible adjustment programs, which will generate the support of donors and creditors, lending on concessional terms such as through IDA and ESAF under appropriate conditionality to minimize potential for moral hazard, clearance of arrears, and development of frameworks for restructuring of debt outside the Paris Club need to be continued.

On private market financing, innovative ways of support also have to be formulated, and this would require closer cooperation between official as well as private sources of financing. For instance, the provision of financial assistance to projects could be complemented by more managerial and technical assistance, particularly in countries where the skills are clearly lacking. Private financing may also be extended by way of joint venture arrangements to enhance effectiveness.

I will make two brief points of emphasis:

I agree with the staff it is important for countries with commercial bank debt problems to make every effort to normalize relations with their bank creditors as a step to regaining access to international capital markets. When combined with strong policy adjustment, this will facilitate an early resumption of private capital inflows. The example of Mexico shows just how rapid re-entry to the capital markets can be when strong policy adjustments are made.

Secondly, I consider the conclusions drawn by the staff on the resilience of developing country security markets post-Mexico, which mirrors the findings in the last capital markets exercise, bears particular emphasis. There is evidence that market participants did differentiate between different country securities on the basis of economic fundamentals, although maybe less so within Asia than within Latin America, as indicated by Mr. Waterman in the last World Economic Outlook discussion. As the staff notes, there are powerful incentives at play, in the form of profit opportunities for better informed investors, that will act to keep prices from diverging far or for long from efficient levels.

Mr. Al-Tuwaijri made the following statement:

I will make a few brief comments on issues with operational relevance to the Fund:

I share much of the staff assessment regarding the debt burden of the most heavily-indebted, low-income countries. The Naples terms provide a welcome window of opportunity for many countries to achieve external debt sustainability. It is clear, however, that some countries will continue to face serious external debt problems, even following stock-of-debt reductions on Naples terms. In these circumstances, other solutions need to be sought. However, in considering new proposals, we must not lose sight of the monetary character of the Fund--which is fundamentally different from that of every other international financial institution. Here, I agree with the views expressed by Ms. Srejber regarding this point.

The World Bank will be considering proposals to help alleviate the debt burden of heavily-indebted, low-income countries. In this regard, the Fund should intensify its coordination efforts with World Bank in this area. Each institution should focus on its respective mandate and expertise. To this end, the Fund should concentrate on the provision of technical assistance, macroeconomic advice, and, where appropriate, financing under the ESAF.

Like other Directors, I would be interested in learning more regarding the suggestion that the Fund supports private debt reduction for low-income countries through a small stand-by in conjunction with an ESAF arrangement. Clearly, great care will need to be taken in this area. Stand-by arrangements, as mentioned earlier, are non-concessional, and such a strategy may ultimately increase the long-term, debt-service problems of these countries.

Finally, I have no problem with the publication of these interesting papers after the appropriate deletion of sensitive information.

After adjourning at 1:00 p.m., the meeting reconvened at 3:00 p.m.

Ms. Lissakers said that the publication of the staff papers--taking into account the comments made by Directors--would contribute to a clearer understanding of the nature of the debt problem faced by several member countries.

The Director of the Policy Development and Review Department said that he was not surprised to find differences of opinion among Directors about the complex issue of external debt. However, he was concerned that some Directors had implied that only three or four countries were severely affected by external debt problems. As Mr. Evans had mentioned, at least 15 countries were affected by severe debt problems.

In Box 10 of the report, the staff had identified several groups of countries that faced debt problems, the Director continued. For four low-income countries that had had rescheduling arrangements with the Paris Club--Cameroon, Madagascar, Sierra Leone, and Zaire--the prospects for a lasting solution appeared to be uncertain. In addition, four other countries appeared to have little prospect of attaining debt sustainability in the medium term. Of the ten countries that had not received concessional rescheduling from the Paris Club--and had been excluded from the detailed analysis in the paper--five, that is, Burundi, Rwanda, São Tomé and Principe, Somalia, and Sudan, faced extremely difficult external debt situations. Although roughly 13 countries had been so far identified by the study, a firm list of the affected countries had not been compiled yet.

If a perfectly agreed analytical framework and complete data and assumptions about export prospects had been available, the countries affected by external debt overhangs could have been classified in a manner convenient to deal with their individual problems, the Director observed. The magnitude of the external debt problem could have been determined in one of two ways: by identifying those countries for which there was no doubt that they could not solve their debt problems on their own and helping that relatively small group of countries only or, alternatively, by identifying those that certainly could solve their debt problems and addressing the needs of all the others. Approaches to solving external debt problems could differ depending on the method used for the identification of countries that needed help.

There was no clear-cut evidence on the impact of severe external indebtedness on investment, growth, and the reform process, the Director remarked. Although the elimination of the debt overhang in Latin America had led to a resurgence in capital inflows and growth, no such evidence could be found in the studies on heavily indebted countries. In fact, some countries with severe external debt overhangs, such as Uganda, also had been able to attract substantial capital inflows and promote export growth.

Views differed as to whether it would be better to deal with debt problems on a case-by-case basis or through a comprehensive framework, the Director noted. Countries with heavy debt burdens, like Uganda, which had committed themselves to adjustment, had been more successful in dealing with debt problems than those that had not. The countries implementing adjustment programs had been able to attract the necessary resources to service their debt--including debt to multilateral agencies--and at the same time, support large current account deficits. The success of those countries raised the question whether a case-by-case approach could work for other countries as well.

Even if the outstanding external debt of the countries in question were to be eliminated, the sustainability of aid flow would remain a problem, the Director remarked. In that context, the efficiency of the use of international aid flows was as important as debt reduction.

The World Bank paper that had been leaked to the press had proposed a comprehensive approach to multilateral debt reduction for countries with strong track records of policy implementation, thereby reducing the potential for moral hazard, the Director stated. The proposals in that paper should be treated as nothing more than options to be considered by the management of the Bank.

The Fund and Bank staff were in the process of analyzing the impact of stock-of-debt reduction operations on the debt situations of the countries that might have exit reschedulings with the Paris Club in the following 18 months, the Director observed.

The narrow spreads in the range of 300 to 400 basis points on recent Mexican stock issues had been a response to the economic adjustment in Mexico, Argentina, and Brazil since the Mexican crisis at the end of 1994, the Director remarked. Although the spreads in those countries had come down recently, they were still higher than before the Mexican crisis, and they seemed to indicate that the market was insisting on risk premia.

There was no legal mechanism for transferring into the General Resources Account the charges received by the Fund for providing assistance to members to overcome debt problems, the Director stated.

Mr. Mirakhor said that his proposal to use charges received by the Fund for debt relief was part of a package that would finance the Fund's involvement in a comprehensive approach to the debt problem. However, according to the argument of the Director, the transfer of SCA-2 resources to the General Resources Account was also illegal.

The Director of the Policy Development and Review Department said that the use of SCA-2 resources could not be treated as transfers. The SCA-2 resources needed to be reimbursed to the contributing countries, whose agreement was needed to put back the resources into the General Resources Account.

Mr. Mirakhor wondered whether a similar mechanism could work in the case of charges.

The Director of the Policy Development and Review Department replied that, if any country agreed voluntarily to put the charges into a trust fund, member countries could use those resources on terms usually applicable to trust funds.

The Chairman said that a premium on the charges would be a tax on the countries using Fund resources for adjusting their economies in order to deal with a debt overhang, and, as such, constituted a constraint to balanced burden sharing.

Mr. Mirakhor replied that the premium on charges should be considered a voluntary contribution. A number of countries had agreed to contribute to the ESAF in order to help low-income countries. As there were few initiatives to solve the debt problems of low-income countries, the Fund had to come up with some approach that worked. The membership should be informed about the seriousness of the debt problem, and the possible approaches to its solution. A similar approach had been adopted in the case of the ESAF.

The Chairman said that he agreed that something must be done on a cooperative basis to alleviate the debt problem. Instead of seeking the support of the most recent debtor countries that were undergoing painful adjustment, it would be useful to have a system that every member was invited to support. In that context, a tax on quotas would perhaps be a viable alternative to the scheme suggested by Mr. Mirakhor.

Mr. Mirakhor replied that the package of comprehensive measures he had proposed was designed to share the burden of financing among the entire membership.

The Director of the Policy Development and Review Department, responding to a comment by Mr. Geethakrishnan, said that the staff had not suggested that geopolitical realities were not an important determinant of aid flows. However, the fact that a number of countries that had received aid flows under suboptimal economic adjustment programs were not receiving those resources any more pointed to a change in the geopolitical environment. More importantly, in the new environment, countries that were adopting adjustment programs were emphasizing the need for poverty alleviation and larger allocations of resources to social sectors.

While official development assistance to countries that had adjustment programs with the Fund and the Bank had increased by 35 percent, similar assistance to ESAF-eligible countries without adjustment programs had increased by only 6 percent, the Director noted. Clearly, countries committing themselves to adjustment programs had experienced an increase in aid flows.

Mr. Evans considered that the publication of a revised staff paper that took into account Directors' views would be helpful for the discussion of the subject at the Annual Meetings. The revised paper, however, should simplify Box 10, which was difficult to understand in its present form.

It was not surprising that evidence on the effects of the debt crisis was difficult to find in poor countries, Mr. Evans observed. However, that did not mean that the effects were negligible or unimportant.

There was no contradiction between a comprehensive framework and a case-by-case approach to the external debt problem, Mr. Evans concluded. Perhaps what was at issue was whether a case-by-case examination should be conducted within a general framework.

The Director of the Policy Development and Review Department replied that the staff had not intended to make a distinction between a case-by-case treatment and a comprehensive approach to the debt problem. If a comprehensive mechanism was established early, countries could be informed in advance about the type of mechanisms available to deal with their debt problems, provided they adopted the appropriate adjustment policies. By contrast, if debt problems were to be dealt with on a case-by-case basis, given different creditor compositions for each country, ad hoc approaches might be needed to handle each case.

Any attempt to make Box 10 clearer would make it less accurate, the Director continued. Because of the uncertainty regarding the conclusions about the debt situation of countries, Box 10 could not be made any clearer. As regards the 14 countries that had been identified by the staff as marginal cases, it was difficult to determine their true situation. Of the ten countries that had not undergone any debt rescheduling--and therefore had not been included in the analysis--Sudan had a serious debt problem. However, at the current stage of the study, the staff had not been confident that it could present a definite list of countries that would need assistance to solve their debt problems.

Ms. Lissakers said that the public could misunderstand the staff papers. In particular, the contents of Box 10 should be presented more clearly, without misrepresenting the degree of uncertainty associated with the figures reported.

The Chairman agreed that, by clarifying some of the questions that Directors had raised, the publication should promote a better understanding of the issues. Furthermore, an appropriate timing for the publication would be carefully considered.

The Deputy Director of the Policy Development and Review Department said that, apart from Côte d'Ivoire, there were only a few low-income countries with relatively large commercial bank debts. Any Fund support for commercial debt relief would therefore be limited to a few countries. For the other low-income countries which had commercial bank debt, the World Bank's debt reduction facility for IDA-eligible countries was the adequate and appropriate vehicle.

The staff was not opposed to the use of concessional resources for debt reduction operations, the Deputy Director noted. However, in 1989, at the inception of the ESAF, the contributors had ruled out the use of ESAF resources for debt reduction operations. Although the staff could not tie ESAF resources to a specific debt and debt-service reduction operation, as in the case of the stand-by arrangement, it could take into account the countries' needs in determining the general level of ESAF access.

Providing small stand-by arrangements for enhancing the debt reduction operations of member countries was not inconsistent with Fund's policies, the Deputy Director remarked. Such stand-by arrangements could be based on a medium-term program of adjustment in the countries concerned. As the segmentation between the set-asides and the supplementary resources from augmentation had been eliminated, there were no technical obstacles to having small stand-by arrangements with members.

Several Directors had wondered whether it would be costly for the low-income countries to use GRA resources, the Deputy Director stated. First, the Fund could provide GRA resources with a view to facilitating a significant reduction in the overall debt service burden of countries. Second, the terms of the borrowing from the Fund would have to be taken into account by the commercial banks in designing an agreement compatible with a country's debt-servicing capacities.

Responding to a question by Ms. Lissakers, the Deputy Director said that the rules governing the ESAF could be modified if the Fund decided to create a self-sustaining ESAF.

The staff representative from the Policy Development and Review Department said that Box 8 of the staff paper concerning debt sustainability emphasized the importance of sufficient financing for countries to reach their growth targets. For example, the detailed scenarios on the 14 countries in the background paper had been based on sustained annual growth in real GDP from 3-7 percent.

Two conditions had to be met for a stock-of-debt operation under the Paris Club, the staff representative remarked. First, a country was required to establish a satisfactory track record of policy implementation for a period of three years. Second, the debt reduction in question had to be an exit rescheduling. Most countries listed in Table 5 would be able to achieve stock-of-debt operations in the foreseeable future, if they observed the two conditions.

Paris Club creditors would decide on a case-by-case basis whether eligibility for Naples terms could be extended to countries that were not yet eligible for those terms, the staff representative noted. For the poorest countries of that group, it was likely that the Paris Club would consider rescheduling on Naples terms, as had occurred in the case of Haiti.

When a debtor country signed an agreement with the Paris Club, it undertook to seek at least comparable terms from other creditors, including commercial creditors, the staff representative concluded. In that sense, the staff had not been optimistic in assuming that countries would receive comparable treatment from non-Paris Club official and from private creditors.

Mr. Evans wondered whether Box 8 could be amended to indicate that growth would be an element in ascertaining debt sustainability.

The staff representative from the Policy Development and Review Department replied that Box 8 could be modified to clarify that external debt sustainability needed to be seen in the context of achieving the growth potential of countries.

Mr. Mirakhor wondered whether the Fund was contemplating technical assistance for members that needed a debt management system.

The Deputy Director of the Policy Development and Review Department said that technical assistance on debt management was provided by the World Bank. However, the Monetary and Exchange Affairs, Fiscal Affairs, and Statistics Departments also provided some technical assistance in that respect. In some recent programs, particularly in the transition economies, the Fund had made considerable efforts to identify cases where better management of debt was needed.

The Chairman made the following summing up:

> Executive Directors welcomed Paris Club Naples terms as representing an important breakthrough for most eligible low-income countries toward reducing their external debt burden to sustainable levels. Most Directors agreed that broad coverage under stock-of-debt operations tailored to individual country circumstances, and at least comparable treatment by other bilateral and commercial creditors, would make it possible for many, though not all, eligible countries with strong track records of adjustment to achieve external sustainability. Such a situation was seen as representing a very serious problem, to which all Directors considered that the international community should strive to find an appropriate solution. While many

Directors agreed with the staff that current mechanisms are sufficiently powerful to handle the debt burdens of most of the heavily indebted poor countries, many other Directors urged the staff to intensify its analysis of the burden implied by multilateral debt, in cooperation with the World Bank and other multilateral institutions, and to consider new mechanisms to ease the multilateral debt burden of the heavily indebted poor countries. All Directors, however, underscored that any new approaches should be consistent with the monetary character of the Fund.

Directors noted that, even after stock-of-debt operations, most heavily-indebted poor countries would remain dependent on aid inflows. They urged donors to increase the share of highly concessional assistance directed to countries persevering with strong adjustment programs, and to continue such assistance after stock-of-debt operations. They also urged these countries to pursue strong adjustment and structural reform policies in order to reach their growth potential and broaden their export base.

Directors, nevertheless, noted that a number of low-income countries would face a heavy debt burden even after a stock-of-debt operation by Paris Club creditors, with comparable action by other official bilateral creditors and by commercial banks, partly due to their high debt to multilateral institutions. They noted that the circumstances of these countries differed widely, as regards both their largest creditors and the state of their adjustment efforts. Many Directors emphasized, however, that for those countries adopting strong adjustment programs, appropriate instruments were already available to provide both continued flow reschedulings and new inflows, including from multilaterals. It was critical in these cases that new flows be provided in amounts and on sufficiently concessional terms to allow these countries to reach their growth potential. In that context, a number of speakers emphasized the critical importance of the continuation of ESAF. As these countries established track records of adjustment, further consideration might be given by all creditors to concerted action, tailored to a country's needs, to attain external sustainability and a durable exit from the rescheduling process. A number of Directors, however, were of the view that current mechanisms, including the policies of bilateral aid donors and multilateral institutions, needed to be re-examined to assure that a secure path to external sustainability could be established.

Directors noted that the heaviest potential debt burden to the Fund arises in the large protracted arrears cases, for most of which settlement does not appear to be in early prospect.

Directors agreed that concern about the sustainability of both total and multilateral external debt service should be reflected in a focus on these issues in country-specific analysis for the heavily indebted poor countries. Such analysis, to take place in concert by Fund and Bank staff, should focus on the appropriate terms for new borrowing, the sensitivity to changes in assumptions on export and new inflows, the implications of external finance for growth, and the fiscal implications of external debt.

Directors noted that among the countries in transition some of those in the former Soviet Union have rapidly accumulated external debt over the last three years. They urged that debt monitoring and management in these countries be strengthened.

Directors noted the further progress made over the past year in resolving the commercial bank debt problems of developing countries. This progress reflected the strength of the economic policy adjustment pursued in these countries and the flexibility in the menu approach, which allows debt deals to be structured to fit individual countries' needs.

Directors found it encouraging that several low-income developing countries were able to conclude debt buybacks during the past year and that a number of others were actively seeking to reach agreements with their commercial bank creditors. Nevertheless, Directors acknowledged that a few heavily-indebted low-income countries face considerable difficulties in dealing with their commercial bank debts. In these cases, the size of the countries' debts and the secondary market price of the claims tend to make the costs of straight buybacks, even at steep discounts, significantly greater than the financing available. To deal with this problem, it might be necessary for the countries to undertake debt and debt-service reduction operations. Directors emphasized that such operations would have to be carefully designed to ensure that they are consistent with the countries' limited medium-term capacity to service debt and consistent with available financing. Many Directors agreed that the Fund could support debt operations for these countries under its current guidelines through the provision of a small stand-by arrangement, to be augmented in support of the operation, in conjunction with an ESAF arrangement, a few Directors, however, believed that it would be inappropriate for the Fund to extend non-concessional financing to those countries with limited medium-term capacity to service debt.

Directors observed that disruptions that spread across developing country security markets in the aftermath of the Mexican crisis may have reflected the generally less developed state of these markets and certain characteristics of some of the foreign investors in these securities. The experiences of the major developing countries in Asia, where disruptions were short-lived, suggest that in the end securities prices respond primarily to changes in economic fundamentals, underlining the importance of consistent implementation of sound economic policies. This is also borne out by recent developments in international capital markets. Investor interest in developing country securities has been sustained by the continued strong performance of a number of countries and the determined adjustment efforts of those that have encountered difficulties.

In light of recent events, Directors considered it important to remind countries of the need for careful management of the government's external debt. Adequate government supervision of external borrowing by public sector corporations and monitoring of private sector borrowing abroad is essential. Directors also stressed that it was particularly important to carefully supervise the activities of the domestic banking system, since financial difficulties in this sector could limit the ability to conduct monetary policy and entail substantial budgetary costs.

The Chairman said that the Fund would proceed with the early publication of the paper on private market financing for developing countries, taking into account Directors' comments and suggestions, not only on editing but also on the timing of publication. The paper on official financing would be published, possibly in late October, taking into account the modifications suggested by Directors.

2. CAMBODIA - 1995 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1995 Article IV consultation with Cambodia and Cambodia's request for the second annual arrangement under the enhanced structural adjustment facility (EBS/95/145, 8/29/95), together with a policy framework paper for the period 1995-97 (EBD/95/118, 8/30/95). They also had before them a paper containing statistical tables (SM/95/237, 9/12/95).

The staff representative from the Central Asia Department made the following statement:

Subsequent to the issuance of EBS/95/145, the Cambodian authorities have provided updated information on recent economic developments which indicates that macroeconomic performance has remained broadly on course with the ESAF program framework. Consumer price data through August 1995 show quarterly average inflation at 8 percent, compared with the program target for 1995 of 9 percent. Budgetary data indicate that fiscal performance through July remained in line with the program, though there has been a recent acceleration in the drawdown of Government deposits. The exchange rate has depreciated slightly over the past weeks to CR 2,530 per U.S. dollar on September 13. Net international reserves of the National Bank at end-August stood at US$95 million, compared with the end-September benchmark of US$84 million.

The supplementary budget has been approved by the National Assembly with only minor modifications. Although the export tax on rubber--originally scheduled for introduction on September 1--has been postponed to January 1, 1996, the Government expects to offset the loss through higher transfers from the operating surpluses of the state rubber plantations. Moreover, the approved budget brings forward to September 1995 the increase in the turnover tax from 2 to 4 percent and the 20 percent excise tax on gasoline; both were previously scheduled for implementation in the context of the budget for 1996.

The structural program is being implemented as scheduled. The Central Bank Law has been approved by the Banking Committee of the National Assembly, and its approval by the National Assembly is expected by end-September. Competitive bidding procedures for government contracts were instituted by prime ministerial decree, and progress is being made with respect to the assignment of financial controllers to each ministry as well as the implementation of a direct payments system.

Mr. Ismael made the following statement:

National reconciliation, achieved through the Paris peace accords of 1991 and sustained by the subsequent democratic elections in 1993, has remained a tangible reality. The pragmatism that has enabled most Cambodians to embrace national reconciliation firmly, has contributed materially to Cambodia's ability to concentrate on the process of economic and social recovery and to deal with an ever present though diminishing security threat. Admittedly, the military threat has adversely affected the budget. However, the 1994 budget outcome, approved by the National Assembly on August 31, corrects the record for 1994. This and the legislative approval of the revised budget for 1995, approved on August 30, demonstrate the Cambodian authorities' determination to maintain transparency in fiscal policy and to continue to meet Cambodia's commitments under the arrangement with the Fund.

The Executive Board completed the mid term review of the first year arrangement under the ESAF on March 8 this year. What was not fully appreciated at that time was the extent of the decline in output growth in 1994--GDP growth is now estimated to have been 4 percent, weaker than the 5 percent reported to the Board at the time of the mid term review, and substantially lower than the program target of 7.5 percent, due to a 20 percent decline in rice production--resulting from alternate bouts of drought and flood. Meanwhile, the inflation picture in 1995 has changed dramatically for the good. Year-on-year inflation slowed to 7.3 percent in August, equivalent to a quarterly average of 8.4 percent. The balance of payments has again been strong and official reserves have exceeded targeted levels. All quantitative benchmarks of the first year arrangement under the ESAF were met, with the exception of the ceiling on external debt.

Strong revenue performance throughout the first year program and restrained non-defense spending held the current deficit to 1.5 percent of GDP and the overall deficit to 7 percent of GDP, both slightly above the program targets. The Government remains firmly committed to channelling all revenues through the budget.

The revised budget for 1995 approved by the National Assembly on August 31, anticipates sharply higher revenues at 9.8 percent of GDP compared to 7.6 percent in the initial financial law. Non-tax revenue doubles to 3.2 percent of GDP due to unexpectedly higher-than-expected timber revenues (1.2 percent of GDP). While log exports have been banned since May 1, 1995, additional revenues will come from the sale by public auction of already felled logs. Tax revenue is up by 0.7 percent of GDP. The implementation in July of increased taxation of petroleum products, and the harmonization of excise tax on other selected goods, effective from September, accounts for over 0.2 percent of GDP with additional excise tax measures envisaged for 1996 but now introduced in September, will add additional revenues of 0.1 percent of GDP. The tax on rubber exports will take effect from January; and non-tax receipts from rubber, in 1995, will yield revenue of 0.1 percent of GDP.

On the expenditure side, the revised defense and security budget at 5.9 percent of GDP is below the 1994 revised outturn of 6.4 percent, although higher than the initial 1995 figure of 4 percent. The Cambodian authorities report the cancellation of two prospective loans that would have further breached quantitative benchmarks and have decided to renegotiate three other loans to secure concessional terms more in keeping with the program.

A Prime Ministerial sub-decree was signed on July 31, 1995, introducing competitive bidding procedures under the Department of Public Procurement within the Ministry of Economy and Finance. This initiative, identified as a September benchmark under the program, should impact favorably on expenditures and substantially improve transparency in procurement.

Cambodia remains dependent on external support to cover part of the current budget deficit. The current deficit is expected to decline in 1996 and disappear in 1997. The Government is highly appreciative of the support which has been provided by the international community. The effectiveness and transparency of budget support is obviously enhanced when made available on a cash basis that avoids the complex, time consuming and costly process of commodity distribution and sale.

The National Bank is continuing to maintain a restrained monetary policy stance in 1995, within the tighter benchmarks agreed for March 1995. Net domestic assets and net credit to government remain within program parameters up to July .

With the help of The Fund/UNDP technical assistance, the National Bank reorganized its Exchange Management Department, in August, to improve the management of official reserves.

Dedollarization of the economy remains a government objective. The successful launch on March 25, 1995 of the new range of banknotes, with the highest denomination of 100,000 riels, took place against a background of a strengthening riel, dollar weakness and restrained monetary conditions. With inflation expected to meet program targets by year end, the prospects for successful longer term de-dollarization have now improved considerably. The planned introduction later in 1995 of a modest issue of Treasury Bills will encourage banks to seek riel liabilities to match riel denominated assets and provide the National Bank a more flexible monetary policy instrument. The Fund provided technical assistance to the Ministry of Economy and Finance and the National Bank, in August, to advance the proposal.

The National Bank has also taken a more active stance on bank supervision, in part in reaction to problems in two of Cambodia's commercial banks. One bank opted for voluntary liquidation after sustaining losses and another had its license withdrawn, in May, after a series of regulatory breaches. The National Bank is confident that no depositors will lose money in either case as the deposit activity was minimal. Regulations on penalties for late reporting and on capital adequacy came into effect in March and May, respectively, and a number of banks have been penalized for late submission of annual audited accounts. The National Bank has requested that The Fund/UNDP technical assistance for bank supervision be extended beyond its current expiration date in November.

The National Bank submitted the revised draft Foreign Exchange Law to the Council of Ministers in early September. It is to be presented to the National Assembly by October.

The National Bank phased out its daily foreign exchange auctions from May 8, 1995, in favor of interventions when needed to reduce daily fluctuations in the exchange rate. One auction was held in July. A number of modest auctions were conducted in

August selling a total of US$1.1 million as the exchange rate weakened upon renewed dollar strength. Maintenance of reserves, above the floor of the program benchmark on official reserves, takes precedence over exchange rate stabilization.

The Government has already concluded bilateral negotiations on debt relief with Japan under the generous "Naples" terms agreed by the Paris Club. The Government has also initiated talks with France, in March, that are expected to be concluded shortly. Negotiations with other creditor nations will follow.

Structural reform is gathering pace. In March, the Government announced the removal of the restrictions on rice exports to take effect in December when the new crop is harvested. Remaining export restrictions are retained for environmental or security reasons. Company registration is now simpler, in line with Chapter I of the new Code of Commerce. The timetable for presentation of revised commercial banking legislation has been postponed to December 1995. The new central bank law has passed all the hurdles en route to the National Assembly, including the committee stage. Its passage was delayed slightly owing to a legislative log jam, but is expected to be enacted in September. The Government will not increase the numbers of civil servants in 1995 and will downsize by 10 percent in 1996 and again in 1997. The Cambodia Development Council (CDC) has streamlined its procedures under the investment law. A government sub-decree on the organization and operations of the CDC was signed on August 26. Articles 81-86 of the Budget Law for 1995 included provisions for the privatization of state enterprises. The two Prime Ministers signed a sub-decree in April 1995, elaborating on those principles.

The Government recognizes the importance of continued expert technical assistance to facilitate the reform process and to help Cambodia attain the benchmarks in the ESAF program. The Royal Government thanks the various providers of this assistance including the Fund, the World Bank, the UNDP, the Asian Development Bank and a number of member countries.

In conclusion, I would like to join my Cambodian authorities in expressing appreciation for the staff's assistance in preparing the second year arrangement under the ESAF. Their fair and balanced appraisal of the economy is most welcomed. My authorities are in broad agreement with the staff's conclusions.

Mr. Tahara made the following statement:

It is welcome that, despite unstable security conditions, the authorities have implemented economic policies that are broadly in line with the first year ESAF program. In view of the fact that the implementation of this ESAF program is crucial for economic recovery and development in Cambodia, and that all the quantitative benchmarks of the first year arrangement were met, I support the staff proposal. I will limit my comments to a few policy issues.

The program target targets for growth rate and inflation in 1994 were missed because of a weather-related sharp drop in rice production. However, owing to the tightened fiscal and monetary policy, the inflation level has been declining in 1995, which is welcome. On the fiscal side, it is important to improve transparency in government transactions and to strengthen budgetary monitoring and control. The measures related to the performance criteria in this area should be implemented as soon as possible.

On the revenue side, the tax reform supported by Fund technical assistance should be developed further. On the expenditure side, security and defense-related expenditures should be used efficiently and reduced over the long run. However, the basic public service needs must be satisfied. In light of the current uncertainty of the security situation, it is appropriate for the authorities to prepare contingency revenue measures.

Regarding monetary policy, eliminating government financing from the banking sector can contribute to containing inflationary pressures. The authorities are planning to issue treasury bills in order to establish a monetary control system, and this effort is welcome. Regarding the planned bank-by-bank credit ceiling, I can understand the necessity of these kinds of measures, as it will take considerable time to establish an efficient market based monetary control system.

In the area of financial sector reform, I expect that with the new central bank law and the financial sector law, a firm legal framework will be established. Plans for a rural credit program are now under development. This program is important from the standpoint of modernizing and mobilizing savings in rural areas, and should be implemented promptly.

Regarding external policy, the authorities have a strategy to promote private sector development by encouraging foreign direct investment (FDI). I endorse this strategy, and the current streamlined approval procedure for FDI. I expect that foreign capital, which can contribute much to the economic development of

Cambodia, will flow on a continuous and stable basis without excessive reliance on fiscal incentives. In this context, development of human resources and fiscal infrastructure should be accelerated.

As for the external debt, the authorities have concluded bilateral negotiations on debt relief with Japan under Naples terms. I expect the authorities to reach agreement with other creditor countries under the same terms.

Finally, I would like to note my authorities' intention to continue to support the Cambodian authorities' efforts to recover economic and social stability and to successfully move to a path of sustainable economic development.

Mr. Kang, speaking on behalf of Mr. Waterman, made the following statement:

I can support the proposal to approve Cambodia's request for the second annual arrangement under the ESAF program.

Cambodia faces significant challenges but is making progress and the staff update indicates that the program remains on track.

As in many transition (and other) economies, fiscal policy will be central to overall economic success and stabilization of the economy. The new tax measures are a step in the right direction but, clearly, administrative capacity on the revenue side needs to be strengthened. It goes without saying that expenditure control will also be very important. It is somewhat disappointing that the authorities have not been able to make the progress that they foreshadowed in terms of reducing defense expenditure relative to GDP to enable a greater emphasis on provision of social services. Clearly, the composition of expenditure will remain an ongoing challenge.

It will be important for the authorities to build confidence in the local currency and reduce the degree of dollarization. Related to that, it will be important to develop instruments as proposed in the local currency to encourage savings and also provide scope for market operations in time. I accept, however, that in the short-term the Central Bank is likely to need to rely on more direct controls over bank lending.

The large number of commercial banks seems to pose a particular challenge for the authorities, especially where they are involved in speculation and foreign currency transactions. So the administrative and prudential oversight of the banks is obviously a key issue. On the face of it, until further progress is made on that front, they would not be much point letting further banks establish operations in Cambodia.

Cambodia's current account deficit is quite large and increasing but that is not inappropriate given its stage of development, but it is important, as the staff suggest, for the financing of the current account deficit to be met largely from concessional sources until foreign direct investment picks up more strongly.

Mr. Fontaine made the following statement:

Cambodia has made substantial progress toward improving its macroeconomic situation in accordance with the program's objectives. The staff's indications of recent strong performance are encouraging, particularly so since the second year ESAF program presents some risks. The 1994 fiscal deficit was kept below the original program targets, but at the expense of appropriate funding for priority expenditures. Better-than-expected revenue performance did not rely on expected increases in domestic tax revenue. The tax revenue measures package is welcome, but the security situation may be one cause of fiscal slippages. In this context, I am pleased to see that the authorities implemented some fiscal measures ahead of the original timetable. I also support the very prudent view of the staff toward lowering the tariff.

The conduct of monetary policy is complicated by the uncertainties surrounding the shift toward the use of domestic currency and the lack of effective monetary control instruments. This clearly calls for a prudent monetary program, and--as stressed by other speakers--continued reliance on direct instruments. Priority should be given in the short term to banking supervision, especially given the large number of commercial banks that have been licensed recently.

Together with these short-term challenges, the program also has to pave the way toward more sustainable growth. The growth objective of 7 percent a year after 1995 may well appear rather ambitious. Sustainable growth as targeted will imply a substantial increase in the investment rate to 24 percent by 1997, while domestic savings will remain low.

External assistance will continue to play a major role. However, its effectiveness is constrained by the very low revenue-to-GDP ratio over the medium term, and by the excessive level of defense expenditures--presently around 6 percent of GDP. Like Mr. Waterman, I noted that the program envisages a further widening of the current account deficit from 12 percent in 1993 to 14.5 percent. This is alarming and needs to be closely monitored.

Against this background, I would emphasize the importance of finding alternative solutions to restrictions on log exports, taking into account, of course, security and environmental concerns; the need to move cautiously in lowering external protection which, with an average effective rate of 20 percent, does not appear to be exaggerated; and the need to protect the external competitiveness of the economy. The staff's recommendation on the exchange rate policy with a view to comfort the reserve position is also relevant from this point of view.

Finally, as stated at the outset of the PFP, good governance is of paramount importance. I support the way the staff and management have dealt with these issues, which deserve continuous close attention in the future. I support the proposed decision.

Mr. Hettiarachchi made the following statement:

Cambodia is a post-conflict country in every sense of the word. It was not so long ago that Cambodia emerged from one of the bloodiest civil conflicts that this world has known in its recent history. At a recent Board discussion of a Staff Report on Post-Conflict Countries, it emerged that there is little that the Fund can do in these countries at the initial stages, apart from providing technical assistance, as such countries are not able to put the pieces together and come out with a credible economic program to elicit Fund financial support beyond the first credit tranche. However, as is evident from the Staff Report, Cambodia has been able to break away from this shackle and is successfully implementing an ESAF Program drawing on beneficially from Fund's financial support. This is a singular credible achievement and the Cambodian authorities deserve our unreserved commendation for it. We also wish to commend the staff for their staunch commitment to promote the cause of economic rehabilitation of Cambodia.

It is worth recalling that the situation in October 1991, with reserves reduced to less than a month of imports, with virtually no administrative apparatus remaining, and with the professional cadres in society virtually wiped out, it was a daunting task for the UN Transitional Authority, backed, inter alia, by technical support from multilateral institutions, to provide a basis for organizing key international support to rehabilitate Cambodia. A review of the current position, such as this Article IV discussion enables, confirms that much has been achieved, though there are still many challenges ahead for the two-year old Government.

We support the general thrust of the strategy for economic rehabilitation built around macroeconomic consolidation, accelerating structural reforms and a balanced growth strategy. The staff report has concluded that the macroeconomic performance during the first year of the ESAF-supported program has been broadly favorable and the authorities have been able to keep to most of the Program's targets. The country has been able to achieve a high degree of fiscal consolidation, despite a rise in expenditure, eliminating the need for expansionary borrowings to finance the budget. The exchange rate has remained relatively stable despite the external current account deficit in 1994 remaining at a higher level than the Program target.

With domestic liquidity at a level higher than the program target, the rate of inflation in 1994 has been considerably higher than the programs target but we are told that more recently it has declined to a single digit level in line with the 1995 program target. Although the output growth in 1994 has been significantly lower than the original program target, this is perhaps understandable in a country where 50 percent of the output originates in the agricultural sector.

The program envisages raising output growth to 7 percent in 1995 and through 1997. This is described by the staff as ambitious but feasible. The direction is appropriate: the authorities want to move growth centers out of the Phnom Penh area, focus on rural incomes, exploit the potential of agriculture and agro-based processing, in parallel with development of a modern sector based on labor-intensive light manufacturing and services sector. It needs to be recognized, however, that with agriculture still contributing to approximately half the total GDP, and with limitations on the provision of rural credit, together with the added exogenous risk, as the crop failure which occurred last year, the growth targets needs to be viewed with some degree of pessimism. In addition, given the very high levels of public and private consumption, the achievement of proposed investment targets would very largely depend on the availability of external resources, another variable factor.

Let me now turn, to some of the major challenges facing the Cambodian authorities and indeed the Fund in sorting out economic problems facing Cambodia. The first relates to the availability of credible and accurate statistical data. Though this is normally mentioned in interventions as an afterthought, in our opinion one of the foremost challenges before the authorities is the development of accurate and credible data. The lack of accurate data on economic variable makes program formulation and implementation that much more difficult. The sharp revisions that had been made to export import data and the "discovery" of an additional non-concessional external borrowing for defense are pointers to this problem. From a position where there was virtually no statistical base just two years ago, what has been achieved is very commendable. Annex II gives an excellent summing up of the qualitative limitations of the data being generated, and puts a caveat of approximation on virtually all the analysis carried out. We agree with staff that technical assistance is going to continue to be an area of critical importance, and would encourage the authorities to maintain a healthy pipeline of technical assistance from all sources for an extended period.

Second, monetary policy. Bank financing of the budget deficit has been eliminated, enabling greater provision of credit to the private sector while keeping NDA within program targets. However, data on monetary developments is at best uncertain, as there is a high degree of dollarization, the elimination of which, as Mr. Ismael notes, remains an objective in the Government's economic agenda. We wish to re-emphasize the need for speedy action on this score, as it would be extremely difficult to prepare a credible monetary program in a dollarized economy, the extent of dollarization is not even known.

Thirdly, there is the problem of a very fragile commercial banking system, consisting of 30 banks doing business virtually out of Phnom Penh, but some without inadequate paid-up capital and others with doubtful practices of accurate reporting. There is therefore a strong case for stepping up the degree of supervision of commercial banks.

Fourth, the quality of fiscal adjustment. Excluding Capital expenditure, which increased to reflect higher aid flows, the current deficit had been kept at around 1 1/2 percent of GDP, below the original program and conforming to the revised program level. Unfortunately, this is qualified by the fact that while the revenue increase in 1994 reflected strong customs receipts, and higher than planned forestry revenues, noncustoms tax revenues have declined. We are inclined to believe that the high dependence on forestry revenue in the past carried with it high environmental risks and the process should be phased out to a more environmentally sustainable level. The excellent box on forestry confirms that there are still many loopholes that will continue to cause leakage of revenue from official coffers, as also cause exploitation to be less than moderate. Forest cover has been reduced to half its 1970s levels, and there is a real danger that this resource may just not be available for exploitation much longer. Accordingly, concerted efforts will be required to minimize the environmental implications of exploiting forestry reserves.

Meanwhile, on the expenditure side the compression had been solely in the non-defense areas. Given the levels of per capita income, it is specially interesting to see how social sector allocations fared. Social welfare and social safety net expenditure in 1994 together amounted to 19.7 percent of current expenditure; national defense amounted to 63.2 percent. Social sector spending amounts to only @ 1.5 percent of GDP, and the MEFP does not assure that these outlays will be protected, leave alone enhanced. We wonder how a fiscal adjustment heavily geared toward cutting-back on social welfare expenditure will be sustainable in a poor country which needs popular support for its economic, and even more so, for political adjustment program. Are the social dimensions of adjustment programs which are being discussed in many a fora these days being adequately safeguarded?

Lastly, some structural issues. There has been some progress on structural reform, but this is behind schedule. A civil service reform has been effected, and the adoption of a strategy on privatization has been completed. However, the problem of demilitarization, or providing training and employment to former army employees, will be a formidable task.

With these remarks, we support the second annual arrangement under the ESAF and extend our best wishes to the Cambodian authorities.

Mr. Hamilius made the following statement:

Cambodia will continue for years to depend heavily on foreign financial assistance, which will make its path to internal and external viability a long and difficult one. However, in light of the impressive macroeconomic achievements of the last two years, there is room for reasonable optimism, provided both the internal and external security situation remains stable. Let me first comment on fiscal policy and then briefly turn to the banking sector.

As is often the case in very low-income countries, fiscal policy, especially revenue policy, is an essential element in enabling the public sector to play its role as an important economic agent. The staff report informs us that budgetary revenues reached 9.5 percent of GDP, which is 2 percent of GDP higher than the original program target. Although one can only commend the authorities for this achievement, this ratio is still low. The new revenue measures in the government's supplementary budget are therefore welcome. Like the staff, we think that a larger increase in domestic taxes, although politically difficult, would have been useful. Higher taxation of petroleum could have served as a contingency measure.

As to the authorities' continuing effort to increase revenues, could the staff tell us if concrete diversification efforts are under way to increase Cambodia's growth potential and provide additional new sources of revenue for the future?

On the expenditure side we very much regret the serious slippages in the security and defense areas. Given Cambodia's fragile fiscal position and given the magnitude of the slippages, the authorities will be well advised to stick to the revised budget, which aims at holding military spending below 6 percent of GDP. This is especially important in light of the generous foreign financial assistance being provided to finance the overall fiscal deficit. I have one last remark on a related issue: Table 4 on page 30 of EBS 95/145 informs us that defense salaries will increase under the program, while other salaries will remain level. The staff's comment on this increase would be welcome.

On structural reforms, the staff correctly stresses that banking supervision needs to be strengthened. That is the only way to create a sound and strong financial sector which will be capable of supporting growth. The staff report also regrets the absence of banking offices in the rural areas, which the authorities consider an obstacle to increasing agricultural output. In this context, it may be interesting to recall the experience of Bangladesh's Grameen Bank, which grants small-scale credits to poor women in rural areas. Perhaps a similar scheme could be devised in Cambodia.

We support the proposed decision and wish the authorities every success in their endeavors.

Ms. Kouprianova made the following statement:

During the first year of the ESAF program, Cambodia's economic transformation process is clearly on track. The economy's performance has been generally favorable, despite the negative impact of the security situation, and bad weather conditions. First of all, I would like to commend the Cambodian authorities for their determination in implementing the measures envisaged under the first year of the ESAF program--all but one of the quantitative benchmarks were successfully reached--and for the significant improvement of the macroeconomic indicators reached in the last few years. Real GDP growth has stayed at the 4 percent level since the end of 1994, investment-to-GDP ratio has increased to 19.5 percent of GDP, and inflation has been reduced. The external position has further improved, as the gross official reserves have increased to $100 million, and the balance of payments position has been further strengthened. Rescheduling Cambodia's external debt will also have a positive impact on the country's external standing in the medium term, and there is a good prospect of obtaining external financing. Especially encouraging is the rise in private capital flows from US$ 74.6 million in 1993 to US$ 159.9 million in 1994. Although there have been slippages in the structural area, progress has been achieved in building a legal and institutional framework for further deepening the reform. The main objectives of implementing the transformation program under the second year of the ESAF arrangement--to restore the macroeconomic stability of Cambodia and to establish a market economy--stay the same as those under the first-year ESAF. The achievement of these objectives seem within the authorities' reach, but much more needs to be done to sustain the early successes. As I agree in general with the thrust of the staff appraisal and support the proposed decision, I will be brief and limit my intervention to emphasizing a few points.

Although some progress that has been achieved in the fiscal area and the current fiscal deficit was actually lower then envisaged at 1 1/2 percent of GDP, further strong efforts in regard both to revenue and expenditure are needed to secure the country's fiscal position in the medium-term. This is crucial for macroeconomic stabilization. On the revenue side, the fact that the revenue/GDP ratio was increased by 2 percent of GDP compared with the revised program target for 1994 is commendable, as this ratio is still low compared with other countries in the region. We concur with the staff's assessment that additional revenue measures are needed to increase revenues, and are encouraged by the authorities' efforts to proceed with the tax reform and the reform of the civil service. On the expenditure side, the authorities' efforts to maintain the present level of current spending in 1995 are encouraging. However, further strong measures are needed to curtail and restructure expenditures--especially unproductive expenditures--in the coming years.

Progress has also been made in implementing measures of monetary policy, but developments in this important policy area must be closely monitored. Consumer prices rose to 18 percent in 1994 which constitutes a two-fold increase over the expected level. However, the measures taken by the authorities on the monetary front have led to the slowing of the pace of inflation--year-on-year inflation was reduced to 7.3 percent in August 1995, and the authorities stand ready to continue their restrained monetary stance, based mostly on the direct controls. The monetary policy conduct is complicated by the high level of dollarization, and we welcome the first steps aimed at the de-dollarization of the economy that have been taken in 1995.

Some positive developments have taken place on the structural front--the ban on rice exports has been terminated, interest rates have been liberalized, quantitative import restrictions have been eliminated, privatization reform and reform of the financial sector are under way. Despite successes achieved in structural policy implementation, the overall performance in this area has been disappointing. Further strong efforts in the structural area are needed to gain momentum, and to ensure further development of an institutional framework for more effective functioning of the economy. Without progress in the implementation of the structural measures the reform will stagnate. The reforms of the civil service and of the military are among those that are presently under way, and the authorities' proposed agenda in this respect is ambitious. The Government's intention to cut the civil service by 20 percent by 1997 is commendable, and will be important for increasing its efficiency in managing the economy. It will also have a significant fiscal impact. As for unproductive expenditure, the Government's plan to establish an efficient military structure, and the first steps taken to decrease sharply the military are encouraging, although they have not yet led to a positive fiscal impact.

The issue of external indebtedness is of vast importance for a country like Cambodia. In this regard we welcome the fact that the Cambodian authorities have achieved progress in negotiating with the Paris Club creditors, and we urge the Cambodian authorities to make stronger efforts to normalize the issue of the country's indebtedness to other official creditors, including the Russian Federation.

With these remarks, we support the proposed decision, and wish Cambodia's authorities every success in their endeavors.

Mr. Ryan made the following statement:

We are largely in agreement with much of the staff's assessment. There are two issue, however, on which I would appreciate clarification.

Foreign direct investment should play a key role in Cambodian development and substantial investor interest is already evident. I wonder if the staff could comment on the approval process for such investment. There is a reference in the staff report to the need for the Government to screen carefully investment projects to ensure consistency with sustainable economic development. I interpret this recommended vigilance as designed primarily to guard against unsustainable activities, such as overlogging, and not an endorsement of industrial policy "targeting." The wording is a bit open-ended, however, so I wonder if the staff could clarify its views in this area.

The dollarization of the Cambodian economy raises some questions over the choice of the monetary regime and its implementation. The authorities have decided to establish a national currency, though currently the riel only appears to be used in government transactions. A national currency offers benefits, e.g., seigniorage; a monetary policy guided by cycles in the Cambodian economy, not the U.S. economy; use of the exchange rate as an adjustment tool. However, there are also risks--namely the risk of inflation and looser financial discipline.

There is a question over whether the balance of these risks and benefits outweigh those of dollarization. Under current conditions, growth has accelerated and foreign direct investment is poised to pick up substantially. At this stage, the downside of dollarization appears somewhat more theoretical than real, whereas the transition through de-dollarization will be complicated.

As the authorities have chosen to pursue a riel-based regime, however, the key questions concern its implementation. Monetary policy is currently anchored essentially by limits on net credit to the Government, which puts a premium on fiscal performance, as the staff paper points out. As dedollarization occurs, the riel monetary base will grow and exchange rate pressures will increase. Currency substitution will be going on at the same time remonetization is taking place. In these circumstances, it will be hard to evaluate whether capital inflows should be accommodated as the counterpart to this process or as a problem requiring sterilization or exchange rate adjustment. Establishing a nominal money or exchange rate anchor is difficult given uncertainties surrounding the equilibrium exchange rate and money demand, but the lack of such an anchor also creates uncertainties that inflation targets will be met. The planned response to inflows, for example, is to build reserves and brake upward pressure on the riel. Downward pressure will not be resisted. A substantial amount of discretion is left to monetary authorities to achieve stabilization goals. A question that arises is whether the lack of an anchor in this situation--even if imperfect--creates a not insignificant risk. Is a firmer anchor or at least a more clearly articulated strategy needed?

We can support the proposed decision.

Mr. Issaev made the following statement:

I agree with the substantive points made by earlier speakers and will limit myself to comments on a few points.

With respect to fiscal policy, further steps need to be taken regarding adequate control over government spending and setting expenditure priorities. More attention should be given to health, education, and social welfare. We welcome the Government's commitment to act quickly in that area.

With regard to monetary policy, new instruments for monetary control should be developed, and confidence in the financial system needs to be created. As far as developments in the rural credit activity are concerned, we agree with the view that it should be consistent with the overall financial stability and the strengthening of the banking supervision. We are impressed by the Cambodian external financial strategy and its success in attracting foreign direct investment. We should stress, however, the importance of the continuation of the public investment program.

With these considerations in mind, we can support the proposed decisions and we wish the Cambodian authorities success in their transition to a market economy.

Mr. Wei made the following statement:

The authorities are commended for achieving remarkable progress in rehabilitating the economy and implementing the ESAF program under difficult circumstances. However, as indicated in the staff paper, the authorities still face many challenges. I am in broad agreement with the staff appraisal, and I would like to make only a few points.

Inflation has been reduced drastically, but the authorities must be vigilant to keep inflationary pressures from reemerging. Output growth has been slower in the last two years, and is unbalanced in terms of regions and industries. It is therefore of critical importance that the authorities implement a balanced growth strategy aimed at attracting private investment activities that would contribute to sustainable development.

On the fiscal side, maintaining fiscal discipline is crucial to achieve lasting fiscal improvement and realize medium-term objectives. Although the budget deficit has been reduced, the authorities still face significant expenditure pressures. Thus, the authorities are encouraged to fully implement the additional tax measures planned in the supplementary budget for 1995 to broaden the domestic tax base. We welcome the recent steps to increase tax revenue, but the revenue-GDP ratio in Cambodia is still low compared with other countries in the region, so it is imperative for the authorities to embark on medium-term tax reform to increase revenue in a sustainable way.

On the monetary side, since the economy is highly dollarized, which limits the scope for effective monetary control and complicates financial management, it is important for the authorities to increase the population's confidence in the local currency through further bringing down inflation.

In this connection, it is indeed welcome to see the authorities aim at dedollarizing the economy. Under current circumstances, while the central bank needs to develop indirect policy instruments, the direct instrument of bank-by-bank credit ceilings is an effective way to exert monetary control. Given the increasing number of commercial banks, the authorities are called upon to strengthen banking supervision and regulate banking activities.

On the external side, we welcome the authorities' medium-term outward-oriented development strategy. Regarding exchange rate policy, the National Bank is setting the official exchange rate daily so as to keep the rate within one percent of the informal market rate. In the meantime, the National Bank is also targeting its exchange market intervention toward meeting the programmed level of international reserves. However, we are not quite clear as to how the authorities reconcile these two objectives. I would appreciate the staff's elaboration on this point.

There is no need to reemphasize the importance of accelerating the structural reforms, which could pave the way for sustained economic growth over the medium term. Further Fund technical assistance would be helpful in facilitating the reform process.

With these remarks, we support the proposed decision and wish the authorities every success in their endeavors.

The staff representative from the Central Asia Department, remarking on fiscal policy and the absence of social safety nets, stated that in the existing circumstances of constrained revenue growth, where defense and security spending consumed a large portion of expenditures, the brunt of adjustments in the past had fallen on nondefense current spending, including basic services. The authorities had recognized that imbalance and, in the supplementary budget, had budgeted an increase in social expenditures. They had also committed themselves, should further budget cuts become necessary, to protect basic services.

The supplementary budget included an increase in the turnover tax, which could raise the level of revenue relatively quickly, the staff representative noted. However, tax reform would require the eventual introduction of a value-added tax. There might also be scope in the future for taxing agricultural output, which currently was not taxed. On the issue of salaries in the defense sector, they appeared to have increased in nominal terms owing to the fact that a portion of the military salaries were paid in rice, the price of which had risen.

On foreign direct investment, the staff supported the current investment regime, which was fairly liberal, the staff representative said. However, greater selectivity in approving such investments might be desirable in order to avoid too many instances where special government benefits were granted. Such benefits generally took the form of very long-term tax concessions, which in effect created monopoly positions that might not be consistent with the authorities' medium-term fiscal objectives, or that might impose additional expenditure burdens on the government.

Two features of Cambodia's financial system were prominent, and distinguished it from other transition economies, the staff representative commented. It was more highly dollarized than those of neighboring countries, and there was little use of the domestic banking system. Both factors hampered the effectiveness of Cambodia's two instruments of nascent monetary policy: the anchor provided by limited bank financing of the budget; and the direct, bank-by-bank ceilings on credit expansion, which applied mostly to foreign currency operations. The authorities hoped that dedollarization would proceed quickly. However, they recognized that the high potential for external economic shocks--along with continued domestic political instability--required a pragmatic stance. The exchange rate was effectively set by the market. The central bank set the official transactions rate within 1 percent of the rate that was established in the market, but it did not intervene to keep it within 1 percent of the market's rate. Should investment inflows increase, leading to faster dedollarization, the authorities in the first instance intended to absorb the excess by increasing their reserve position rather than by letting the exchange rate appreciate. The staff thought that such a stance was appropriate.

Mr. Ryan said that he understood the staff representative to mean that, as dedollarization occurred and as capital inflows and currency substitution resulted in upward pressure on the exchange rate, the central bank would respond through intervention, which would in turn increase the real monetary base. In that situation, what would the authorities use as guides for an expansion of the base, assuming it exceeded the increase in money demand, in a manner that would not encourage a surge in inflation?

The staff representative from the Central Asia Department acknowledged that there was uncertainty about how that process would proceed, how quickly confidence would be established, and how rapidly domestic currency use would expand. The monetary program would need close monitoring of real indicators: the exchange rate, the inflation rate, and the levels of reserves. The staff could not provide precise indication at the present time as to when the switch from one strategy to another would be made.

Mr. Ismael made the following concluding statement:

> In my concluding statement I will confine myself to four points:
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> On behalf of my Cambodian authorities I wish to extend, first of all, the gratitude to the Executive board's advice and support for the Second Annual Loan for Cambodia Under the ESAF in support of their 1995/1996 macroeconomic and structural program. I also want to thank the staff for their comprehensive responses to Directors' questions and comments, thereby easing my task in making my concluding statement.

In discussing Cambodia, let us not forget that this country, more than any other developing country, has just emerged from 20 years of tragedies with all the resulting physical, psychological and material suffering. Therefore, it is understandable that, under the circumstances, inadequacies persist and uncertainties are not yet resolved.

However, as can be observed, the authorities do not shy away from taking courageous actions to cope with and resolve the problems the country is faced with. Certain measures taken are even very progressive such as the drastic downsizing of the military forces, the pre-shipment inspection contract with Societe Generale de Surveillance and the centralization of foreign borrowings in the hands of the Ministry of Finance. Just imagine the courage and the risks involved in demobilizing 2,000 Generals and retaining only 150; reducing 12 Army divisions to 3 divisions with practically no safety net available to cushion the impact; the risk that domestic security could be jeopardized through the mercenary activities of the demobilized troops. If we take Indonesia as a comparison, Indonesia was faced with the demobilization of its freedom fighters after Indonesia's independence was recognized. The answer to assimilating the troops back into civilian life was, among others, a land settlement scheme in which they were offered land to work. Unfortunately, soldiers do not necessarily make good farmers and, instead, they chose other means of supporting themselves to the detriment of the civilian population. It took Indonesia several years to find ways of assimilating the former military into civilian jobs.

Although political stability was established in 1967 and the development plan launched in 1969, it was not until 1984 that Indonesia had a pre-shipment inspection contract concluded with SGS. But, even today, this action is still opposed by numerous individuals because of the loss of monetary gain by vested interest groups. Similarly, it was not until 1975 that Indonesia decided to centralize foreign borrowing, but only after the State Oil Company crisis. Here again, there were individuals opposed to centralization because of the loss of financial gains from foreign borrowing transactions.

In the final analysis, what is most important is that the authorities' vision remains clear: that is, there is a commitment to the objectives of economic development and political stability, through the rule of law, good governance, transparency, administrative and military reform, democracy and respect for human rights.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the staff appraisal. They were impressed by the substantial progress made over the past years in the process of both social and economic recovery, and noted with satisfaction the generally favorable performance during the first year of the Government's ESAF-supported program. Despite difficult circumstances, output growth had been substantial--though lower than envisaged, inflationary pressures had been contained by continued fiscal restraint, and the external position had improved.

Directors stressed that maintaining fiscal discipline would be essential for the consolidation of macroeconomic stability and the realization of the Government's medium-term objectives. They expressed some concern about the potential for fiscal slippages, given the security situation, and emphasized that fiscal reforms would be required to achieve a lasting improvement in the fiscal situation. The implementation of new tax measures in the supplementary budget for 1995 was an important first step toward broadening the domestic tax base and raising tax revenue from its currently low level. Achievement of the budgetary targets would also hinge critically on firm control of the current expenditure and sustained efforts to contain military spending.

Directors pointed to good governance and transparency in government operations as vital for sustaining private sector confidence and the support of the international community. In that context, they underscored the critical importance of full implementation of measures aimed at strengthening budgetary monitoring and control, and urged the authorities to follow through with their announced intentions in this area, particularly as regards revenue from forestry operations and from government contracts.

On monetary policy, Directors noted the limited scope for effective monetary control through market-based instruments, and observed that the high degree of dollarization substantially complicated monetary management. They accepted that the authorities would need to rely on pragmatic and more direct approaches--including bank-by-bank credit ceilings--while indirect instruments were being developed over the medium term. Directors recommended a significant reinforcement of banking supervision capabilities to help strengthen Cambodia's financial system.

Directors noted that Cambodia's balance of payments outlook was contingent on substantial amounts of new external financing from both official and private sources. Such support remained essential to meet Cambodia's infrastructure needs and to rebuild its productive base. In this connection, Directors endorsed the authorities' outward-oriented growth strategy based on the private sector and on the reintegration of Cambodia into the regional and world economy. This strategy should help foster inflows of foreign direct investment. Directors welcomed the adoption of a liberal foreign investment law and the streamlining of approval procedures. Some Directors thought that a liberal investment framework and investment in human capital and infrastructure improvements would be more effective in inducing foreign direct investment than reliance on fiscal incentives.

In view of Cambodia's limited debt-servicing capacity, Directors fully endorsed the authorities' decision to refrain from nonconcessional external borrowing and to contract debt only after economic viability and prospective returns have been assured. Directors also noted the progress that had been made in normalizing relations with official bilateral creditors, and expressed their hope for a rapid conclusion of bilateral negotiations.

Directors commended the authorities for the initial progress that had been made in advancing their broad agenda of structural reforms, and encouraged them to accelerate the pace of implementation. Early action was particularly important in the key areas of public enterprise reform and privatization and in the reform of the civil service and the military.

Directors commended the authorities for the significant progress that has been made in rebuilding the statistical data base, but also noted the need for further substantial improvements in all principal areas.

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

The Executive Board took the following decision:

1. The Government of Cambodia has requested the second annual arrangement under the enhanced structural adjustment facility.

2. The Fund has appraised Cambodia's progress in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper for Cambodia set forth in EBD/95/118.

The Fund approves the arrangement set forth in EBS/95/145, Supplement 1.

Decision No. 11069-(95/88), adopted
September 15, 1995

3. ISRAEL - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with Israel (SM/95/186, 8/1/95). They also had before them a background paper on recent economic developments in Israel (SM/95/220, 8/30/95), as well as a background paper on recent economic developments and prospects and progress in institution building in the West Bank and Gaza Strip (SM/95/222, 9/1/95).

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

> Since the Article IV consultation discussions in early June 1995, there has been a basic continuation of the economic trends that were in evidence in the first half of the year. In particular, the economy continues to operate at a very high level of activity, domestic savings remain low, and the external trade balance remains in large deficit. The main features of these developments, which underscore the call of the staff appraisal for the early introduction of policies to strengthen public savings, may be summarized as follows:
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> Preliminary national accounts and employment data for the second quarter of 1995 suggest continued strong economic growth. Thus, for the first half of 1995, real GDP grew at an annual rate of almost 8 percent with respect to the second half of 1994, while the overall unemployment rate is estimated to have declined from 6.9 percent to 6.2 percent between the first and second quarters of 1995. Economic growth during the first half of 1995 was led by a 10 1/2 percent increase in private consumption demand and by a 10 1/4 percent increase in fixed investment. In contrast, the external sector made a negative contribution to economic growth in the first half of 1995, as export volumes increased at an annual rate of barely 1 percent over their corresponding level in the second half of 1994 and as import volumes increased by almost 10 percent. Further indications of economic strength are provided by the rapid rate of increase in industrial production and by the further increases in the level of the Bank of Israel's index of leading economic indicators.
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> Trade data for August 1995 suggest a further significant widening in Israel's external trade deficit. The trade deficit for the first eight months of 1995 is estimated at US$6.9 billion, or 33 percent above its level in the corresponding period of 1994. In the first eight months of 1995, imports (excluding ships, aircraft and diamonds) in U.S. dollar terms were 22 percent above their level in the corresponding period of 1994, led by a large increase in consumer goods imports. Exports were only 10 percent above their corresponding 1994 level. These data are consistent

with a forecast external current account deficit of around 7 percent of GDP in 1995.

Reflecting sharp declines in the prices of fruit and vegetables, consumer prices increased by 2.8 percent in the first seven months of 1995, or at an annual rate of around 5 percent. Excluding fruits, vegetables, housing, and controlled prices from the index, inflation has been more of the order of 10 percent in the first seven months of 1995. Over the past twelve months, wholesale prices have increased by 11 percent. Moreover, inflationary expectations, as reflected by the interest rate differential between indexed and unindexed one-year paper, increased to around 10 1/2 percent in August.

Following a reduction in its lending rate by 0.3 percent to 13.2 percent in early July 1995, the Bank of Israel has maintained its lending rate unchanged at that level over the past two months. The decision to maintain the present level of interest rates was based on the continued rapid rate of growth in the monetary and credit aggregates and on the rise in inflationary expectations. M-1 grew at an annual rate of 22 1/2 percent in the first eight months of 1995, while, led by credit denominated in foreign currency, non-directed credit grew at an annual rate of around 25 percent.

In early June 1995, the Bank of Israel significantly reduced its degree of foreign exchange market intervention following the widening of the exchange rate band from 5 percentage points to 7 percentage points around the central rate. More recently, however, the Bank of Israel has responded to continued private sector foreign exchange borrowing and to the appreciation of the currency by renewed foreign exchange market intervention. In July and August, the Bank of Israel purchased around US$1 billion in foreign currency from the private sector, bringing the cumulative amount of such purchases to US$4.5 billion since the beginning of the year. At present, the exchange rate is around 4 percentage points more appreciated than its central rate, implying a cumulative depreciation of only around 2 1/2 percent in the nominal exchange rate vis-à-vis the currency basket since the beginning of the year.

At the end of August 1995, the Cabinet approved the Ministry of Finance's 1996 budget proposal that is to be submitted for parliamentary approval by October 1995. The main objectives of this proposal are to support non-inflationary economic growth of around 5 percent and to limit the external current account deficit to US$4 billion, or around 5 percent of GDP, in 1996. To that end, the Government's domestic budget deficit is to be reduced to 2.5 percent of GDP in 1996 from a targeted level of 2.75 percent of GDP for 1995. This reduction is to be effected through across-the-board cuts in public expenditures totalling NIS 1.7 billion from their on-present-policy levels, including delays in planned wage increases and a slowing of promotions in the security services, and yet to be specified increases in revenues totaling NIS 215 million. At the same time, the Government is to proceed with those tax reductions announced for middle-income wage earners from September 1, 1995 and with a scheduled 1 percentage point cut in the corporate tax rate to 36 percent effective January 1, 1996.

Extending his remarks, the Deputy Director noted that, just that morning, the Israeli Central Bureau of Statistics had released the inflation figure for August, which showed an increase of 1.2 percent compared with an increase of 0.2 percent in May, and which brought the 12-month rate of inflation close to 9 percent. Underlying the acceleration of inflation were very sharp increases in housing prices that were associated with the recent recovery in the U.S. dollar. However, the rising inflation, together with the widening in the trade account in August, the sharp fall in unemployment, and the rapid increase in the monetary aggregates, were collectively a further indication that the economy was overheating.

Mr. Wijnholds made the following statement:

The first half of the 1990s was a very favorable period for the Israeli economy: the economy grew rapidly, as did exports and investments, while unemployment rates, inflation, and the external debt to GDP ratio fell substantially. During this period the Israeli economy was faced with two major supply side shocks: a large-scale immigration wave, especially from FSU countries, that enlarged the country's population by 13 percent; and a substantial acceleration of the pacification process in the region, which is enhancing the prospects for a strong growth process for Israel, as well as for its neighbors. Though these are, in principle, positive shocks, their management was a main challenge for the Israeli authorities in those years. In the coming period emphasis will shift to a more mainstream brand of policy challenges, particularly the balance of payments and disinflation.

The performance of the real sector in 1994 and in the first half of 1995 was very strong: the effective absorption into the economy of the human-capital-rich immigration stimulated activity. The better prospects for finding peaceful solutions to conflicts between Israel and its neighbors had, as well, a positive influence in that respect. GDP rose in 1994 by 6 1/2 percent in real terms, and the rate of unemployment fell to 6.5 percent in the first half of 1995. The unemployment rate among the new immigrants fell sharply to 12-13 percent, pointing to the success of the government strategy for the absorption of the immigrants in the labor market, namely in the private sector. The large increase in labor supply, coupled with the strategy of avoiding a bloated public sector, pushed downwards the private sector wage level, thus helping maintain competitiveness. The wage level in the private sector has not been influenced so far by the wage hikes that were granted in the public sector in 1994.

The implications of the expectations raised by the peace process and a surge in the demand for housing were significant also in nominal terms. The inflation rate in 1994 amounted to 14½ percent, thus missing the inflation target of eight percent. This outcome was brought about primarily by a sharp rise in the price of housing, caused by a surge in demand for the same, and by an accommodating monetary policy. Once this negative trend was recognized the Central Bank took action; since the third quarter of 1993 and all through 1994, the monetary screws were tightened and more decisively so in the last quarter of 1994. Interest rates have since been kept at high levels in real terms. The developments in the first half of 1995 in this sphere are encouraging: the trend of inflation is estimated to be down to nine percent. The actual rate of inflation (on which the inflation target is set) is much lower, 5 percent in annual terms, due among other things, to a cyclical fall in prices of fruits and vegetables. All in all, the 1995 inflation target of 8-11 percent seems quite reachable. The fall in measured inflation in 1995 necessitated a corresponding lowering of nominal interest rates, in order to prevent real rates from rising and choking activity.

Keeping a high real interest rate in a managed float regime proved to have its complications vis-à-vis the external sector. Capital inflows, mainly reflecting Israeli firms borrowing abroad, put upward pressure on the exchange rate leading to a surge in foreign reserves, as the central bank executed sterilized interventions. In spite of the limitations for conducting monetary policy in a small open economy, it is easy to recognize the advantages of operating within the diagonal exchange rate band; it prevented a sharper deterioration in competitiveness without loosing a nominal anchor. It is clear, on the other hand, that in the longer run monetary policy will be able to hold the line only if assisted by fiscal policy. In mid-1995 the diagonal band was widened from ± 5 percent to ± 7 percent, in order to enhance the built-in flexibility of the exchange rate mechanism.

While the inflationary divergence of 1994 has since been tamed, this is not the case with the current account balance of payments deficit: it is projected to widen from 4 percent of GDP in 1994 to 5 to 6 percent in 1995. This deterioration is strongly connected to a not fully understood decline in the private sector savings rate, while the surge in investments in the principal industries continues. The number of possible explanations consistent with this phenomenon--the optimism related to the peace process, the public-sector wage policy, the changed expenditure structures of new immigrants, once absorbed into the work force--makes it difficult to recognize whether the change is transitory or not, and therefore whether a counterbalancing fiscal policy change is needed. This disturbing uncertainty is conveniently cushioned by Israel's very favorable foreign financing possibilities, especially those guaranteed by the US government, in connection with the immigration wave.

In 1994 fiscal policy operated in the hitherto effectively functioning framework of the Deficit Reduction Law: a yearly lowering of the domestic budget deficit. The 1994 budget deficit turned out to be lower than planned (2.2 percent of GDP), due to good tax revenue collection, caused by the high level of activity. The 1995 budget deficit target of 2.75 percent (down from the 3 percent target for 1994) is in reach, and a further reduction to 2.5 percent for the 1996 budget has already been approved by the Government. The reasonable budget performance of recent years, while the economy is growing fast, has enabled a smooth reduction of the public debt from its very high past levels to around 90 percent of GDP. The Israeli authorities are well aware of the important role fiscal policy plays in the sustainable growth process and intend to remain prudent in this respect, even if large-scale fiscal needs, connected to the peace process, materialize.

The burden of slowing down inflation, in accordance with inflation targets set by the government, is fully accepted by the Bank of Israel and monetary policy is, and will continue to be, conducted accordingly. The substantial capital inflows that accompany the strict monetary stance are of concern to the authorities and necessitate sterilization; some erosion of competitiveness is, as well, a side effect of the strong monetary medicine.

Over the past 2 years there has been a highly welcome acceleration in the regional peace process that carries potentially profound benefits that go well beyond the economic sphere. Of special importance in the context of today's Board discussion, is the prospect that this changed atmosphere provides for the rapid economic development of the West Bank and Gaza strip under an increased degree of empowerment of the Palestinian Authority. It bears repeating that the Israeli authorities attach the highest importance to the satisfactory economic development of its neighbors, which they view as an essential prerequisite for lasting peace in the region. A very constructive element in this context has been the dedicated and highly professional assistance provided to budgetary management and to institution building by the Fund and the World Bank. The authorities are happy to take this opportunity to express their sincere appreciation for this important work and to reiterate their desire to continue cooperating with the international organizations to the fullest extent possible in these efforts.

While in recent years fiscal policy has played a major role in addressing the external shocks, future emphasis will have to be given to dealing with balance of payments problems. Monetary policy is already bearing the brunt of keeping a steady economic course--namely a gradual decline in inflation and an elimination of overheating. This stance is a reasonable interim approach while one expects a reversal in private savings to materialize or, alternatively, awaits better understanding of their long-term reasons. The very strong position on the external front--a high level of reserves and large undrawn balances under the US loan guarantee program--does, as well, provide a comfortable maneuvering space, without getting exposed to imminent risks or having to resort to drastic and premature changes in course.

Mr. Murphy made the following statement:

The Israeli economy has recently been characterized by strong economic growth and some remarkable policy achievements. First among these must be accommodating the latest surges of immigration and at the same time significantly reducing the domestic unemployment level. Compared with past trends, the authorities have built somewhat on the favorable fiscal turnaround which had been in evidence, though their efforts appear to be weakening in the last year or so. Inflation which was off track is being pulled back into line, though the required stance of monetary policy, in light of the fiscal position, poses its own difficulties. Structural reforms cover both the very bright spots associated with turning to the private sector to successfully absorb immigration, and the more disappointing outcome in relation to stalled privatization.

I agree generally with the staff and pick a few points for emphasis.

I think the staff are right about the need for caution and an extra effort on the fiscal front. A number of factors support this view. Let me mention, in particular, three: the most recent fairly modest budgetary consolidation steps and the need to reduce public debt, uncertainty regarding the evolution of private sector savings behavior, and the strain being carried by monetary policy in the absence of greater progress on the fiscal front.

The 1995 budgetary exercise is somewhat disappointing, though I am not suggesting that it is a cause for alarm. The authorities set their sights on targets which are improvements on what had been targeted for the preceding year, even though they are less ambitious than the actual outturn for 1994. As of now, it looks as if 1996 will see some improvement in targets, but still not up to the strength of the performance last year. It is important to bear in mind that the greatest recent progress in fiscal adjustment occurred with much higher-than-anticipated tax revenues, a development which could not be expected to be continued--indeed is not continuing through the middle of 1995. Further, the scope for discretionary adjustment on the revenue front if buoyancy is not present appears fairly limited, given the way in which the burden of taxation has been increasing (47 percent last year, with marginal direct taxation of 60 percent). Accordingly, the brunt of ongoing adjustment must fall on expenditure control and reduction. The timing in the electoral cycle for such an emphasis in the requirements of budgetary discipline is not propitious.

In the circumstances, one can well understand the staff's exhortations to overperform in 1995 to the extent possible, though a discreet extra effort in following years is also required.

Great strides have been made in reducing the public debt/GDP ratio in the last decade to just over 90 percent, but it still remains very high. The 1993/94 reduction from 99 percent to 92 percent is a good illustration of what can be achieved if the budgetary stance is right, or turns out that way.

The staff correctly highlight the uncertainty surrounding the decline in the private sector savings ratio. Clearly, they feel that it is at least in part a structural change calling for some countervailing action on the fiscal front. Even if it were not clear cut that the changes are structural, the very existence of this uncertainty should evoke a cautious fiscal approach--suggesting assumptions which do not rely on past experience of higher private sector savings ratios.

The burden being carried be monetary policy in the absence of adequate fiscal restraint has created a range of difficulties for the authorities. On the one hand, the staff are pointing to the potential for adverse developments on the trade front. On the other hand, the authorities have at their disposal their interrelated monetary and exchange rate stance which has been calling for substantial sterilization operations and required ongoing interest differentials. The sustainability of this set of policies and the results which they generate is highly questionable and should push the authorities to a much more forthright confrontation of the fiscal position.

On structural issues the pension reforms undertaken by the authorities appear to be a containment exercise with guaranteed liability for the government in respect of the problem incurred so far, rather than measures to cure the difficulty. While it may be legitimate to argue that the reforms are better than what would have evolved in their absence, it is also reasonable to criticize them for not facing up to adequate future financing, and a role for government in the capital markets more in line with the direction in which it had been heading prior to these reforms. The staff argue for further reform in this area. To the extent that it is possible to undertake it, a comprehensive approach to reform is called for; the task of complex reform in such an area as pensions cannot be visited from year to year.

The stalled privatization program is a bit of a disappointment, though the detail of the RED reveals some positive aspects. First, the authorities have faced up to vested interests in a small number of cases, and are proceeding with some divestitures. Second, interesting thinking has gone into the options arrangements which are envisaged for the financial sector. I have some sympathy with the authorities in relation to their desire to put in place an appropriate regulatory framework prior to privatization in certain cases, but would urge them to accelerate the whole process.

Mr. Abbott made the following statement:

Over the past few years, the Israeli economy has mastered some exceptional challenges: an unsustainable government debt burden has been brought down from 172 percent of GDP in 1985 to 92 percent of GDP in 1994; immigration that added 13 percent to the population just since 1990 has been absorbed and employed; growth has been sustained at an average rate of 6 percent. These successes have required determined policy discipline sustained over several years.

The economic challenges now before Israel are not of such historic significance, but the staff report indicates that policy adjustments need to be made to be sure the Israeli economy fully exploits the opportunities that have been created.

Growth is good, employment is high, and inflation is being corralled.

There are indications, however, that imbalances are putting stress on the sustainability of the current favorable environment. On past standards, labor and capacity limits are being stretched. Excess demand growth is reflected in a widening current account deficit that this year will reach 6 percent of GDP. Labor markets in the private sector are highly competitive with some erosion of real wages as the expanding labor force prices itself into jobs. In contrast, in the large public sector, employment is protected and generously compensated. The capital accumulation needed to equip the enlarged work force is constrained by a falling saving rate. Monetary policy has veered from accommodation to tight restraint and management of the diagonal band exchange rate regime has become more complex.

I agree with the staff that Israel does not face immediate financial problems but that medium-term structural issues need to be given priority to bring the economy on to a more balanced and sustainable growth path.

Although the budget deficit and government debt have been brought down, fiscal policy needs further adjustment both to expand domestic saving and to bring a better balance between the public and private sector. Spending and taxes are still quite high for a country at Israel's income level. Tax reductions for both households and business were to have been implemented on the first of September. A lower tax burden is to be welcomed, but stronger expenditure restraint is needed to make the overall fiscal stance fit the needs of the economy. The 1996 budget anticipates a reduction in the domestic deficit from 2.75 percent of GDP to 2.5 percent of GDP. This narrowing will make only a minor contribution to national saving at a time when a stronger saving effort is crucial. We are pleased to see that the budget leans against the winds of rising payroll costs in the public sector, but this an area that needs more radical surgery.

Some useful pension reforms were introduced this past year, but more comprehensive reforms are needed to put the system on a sustainable footing. The system is now substantially under-funded. Reforms that moved toward a fully funded system would contribute to the macroeconomic need for higher national saving.

Privatization has stalled. This is unfortunate as there are large opportunities for rationalization and improved productivity. The vitality that is currently being demonstrated in the private sector ought to be allowed to re-energize the corporate entities that are now cosseted in the public sector.

Monetary policy now is working in the shadow of mistakes made in 1993 when policy was loosened prematurely. The subsequent tightening in 1994 was entirely appropriate to head off inflationary pressures. Nevertheless, a consequence is that inflation remains above official objectives and interest rates remain high in nominal terms. As a result, movements within the diagonal exchange rate are out of phase with the internal requirements of an anti-inflationary monetary stance. The current alignment of interest rates and exchange rates fosters capital inflows and real currency appreciation.

As the staff notes, there is still some scope within the widened band to allow a little nominal appreciation that might discourage capital inflows while allowing monetary policy to bite down on inflation. This scope should be exploited to make sure decisive progress is made in reducing inflation.

Moderated inflation could allow moderated nominal interest rates and relieve some of the tension that now exists within the diagonal band regime. Given the size of the current account deficit, however, significant sustained real appreciation of the sheqel would not be desirable. To truly square the circle of internal and external balance, what really is needed is increased national saving. The best thing the authorities could do to achieve this is to make more substantial progress in lowering the budget deficit.

Mr. Fukushima made the following statement:

I am pleased to note the authorities' efforts, described in Mr. Wijnholds's statement, to achieve continuous high growth. I commend the authorities' flexible reaction toward disinflation. Since I agree with the thrust of the staff appraisal, I will make just a few comments for emphasis.

On fiscal policy, it is regrettable that the fiscal deficit is again on an increasing trend, with an overall tax rate at 50 percent. More emphasis should be placed on reducing expenditure. With respect to monetary policy, the authorities' controls on the interest rate and the diagonal exchange rate band have been really successful so far. I expect the authorities to maintain a flexible policy.

On structural reform, it is disappointing that the privatization process is behind schedule, especially in terms of the increasing fiscal deficit. The staff paper mentions that the recent slowing of the privatization process reflected the depressed conditions in the Israeli stock market. I would appreciate it if the staff could provide some background information on this point. I can see the point of the authorities' intention to enable all citizens to purchase shares in designated enterprises. From the experience of the Japanese economy, however, I would like to note that the timing of the distribution and the price should be decided prudently, so that purchasers would not be damaged by speculative transactions and paper loss.

With regard to the West Bank and Gaza Strip, I hope more normal trade flows from and to the WBGS will be maintained. I would like to conclude by wishing the authorities every success in the future.

Mr. Shields made the following statement:

It is rather a pleasure to be dealing with a country where the problems are essentially those of success. As Mr. Wijnholds' statement points out, the 1990s have proved so far to be very successful for the Israeli economy. By impressively absorbing substantial flows of new immigrants and embracing the new prospects for peace, good management has helped the economy to grow in most years at about 6 percent. This has brought unemployment down to perhaps 6.2 percent and probably, amongst established members of the population, below rates last seen in the boom years of 1987.

At the same time inflation, whilst much too high last year at over 14 percent, has not yet shown the worrying tendencies of past decades. New export markets have been won and private investment has stayed strong. In addition, the high public debt ratios which plagued Israel in the past have been attacked with determination so that the level is now well below 100 percent, helped particularly by fast economic growth rates.

The problem, well brought out in the staff paper, is that the party has gone on a little too long. The signs of overheating are now clear. On the external side, not only is the level of the current account deficit high at perhaps 7 percent this year but the performance of exports and imports described in the supplementary staff note suggest a striking recent deterioration in performance. Whilst imports have been 22 percent higher this year than last, export growth has slowed to 10 percent. Published inflation figures may look good because of low food and controlled prices but the underlying rate is probably close to double figures. Although wages growth in the private sector has so far been modest, it may not be long before the tightening in some parts of the labor market starts to make its presence felt.

With such evidence, the clear message must be that policy needs tightening. But what do we see when we look at fiscal policy over the last year? A domestic fiscal deficit which may grow from 1.9 percent in 1994 toward the budget target of 2.75 percent in 1995 compounded by additional expenditure from the hang-over from last year's supplementary budget and an extra .75 percent of GDP from the external public deficit. This represents a sizeable fiscal stimulus, particularly when one takes account of the cyclical bonus to the budget from declining unemployment.

The staff report well recognizes this. The only surprise is the mild terms in which it is judged. I quote: "we must regret the relative lack of ambition in the 1995 budget." I fail to see any ambition in it at all except in terms of previous out-dated targets. It was in the wrong direction.

The message for the 1996 budget must therefore be clearer. I cannot believe that sticking to the government's domestic budget deficit target of 2.5 percent of GDP in 1996 can be consistent with the government's stated objectives for inflation and the current account deficit. A significantly lower target is required if the stated inflation target is to have any real meaning.

Of course, there could be a sudden change in private sector behavior--perhaps a restoration of the savings ratio--which would reduce the need for fiscal action. But, I do not see any serious suggestions that it is about to happen. Meanwhile, the public sector debt position is such that--despite recent improvements--the long-term case for further fiscal improvements is clear.

One might normally expect monetary policy to be able to off-set part of the fiscal problem in the short-term, but it rather looks as if, in Israel, it has already reached the limits of its effectiveness. The diagonal exchange rate band seems to have served the economy well as a reliable anchor, but it is now over-constraining policy; achievement of both the exchange rate target and limiting domestic inflation seems impossible. The diversion of so much domestic borrowing to external sources as a result of high domestic interest rates and relative exchange rate certainty means that private credit simply cannot effectively be controlled by domestic monetary policy--companies can carry on borrowing. The quasi-fiscal costs of intervention and sterilization are further reasons to suspect that there is just no room left for tighter monetary policy within the band--and indeed interest rates are coming down.

The other possible route for monetary policy is to allow further room within the exchange rate band for exchange rate appreciation. However, it probably cannot go much further without accepting that the "appreciated" limit of the band must be breached. This would then turn it into a different sort of constraint: perhaps a one-sided crawling peg. I see some attraction in this--but only as a second-best policy to fiscal retrenchment.

If the exchange rate is not allowed to appreciate further, the choice is stark: either give in to inflation or take tougher fiscal action.

The size of the adjustment needed on the fiscal--and on the current account--deficits is, of course, open to dispute. But with the prospect of added long-term fiscal costs from what looks like a half-completed--although welcome--pension reform to come, an election next year, and uncertainty over what would be a equilibrium current account deficit, in the absence of US debt guarantees, I would be inclined to go for a substantial fiscal cut.

Turning to the background paper on the West Bank and Gaza Strip, I have three comments.

I welcome the analysis of the Palestinian Administration's (PA) finances. It is clear from this how sensitive the Palestinian economy is to actions by Israel particularly in its commitment to largely free trade with WBGS and to labor movements. It would also be helpful if there were more transparency over the use of surpluses of the Israeli civil administration.

I welcome the recent passage of legislation allowing transfer of revenue 'clearances' in respect of VAT paid by West Bank Palestinians living outside Jericho. But, I would encourage Israel to speed up passage of additional legislation allowing the transfer to the PA of a portion of the income taxes paid by West Bank Palestinians working in Israel.

In our intervention on Jordan, we touched on the issue of the circulation of Jordanian dinars (JD) in the WBGS. For consistency, I should repeat our suggestion that the Jordanians and PA build on the agreement they have reached concerning JD as legal tender in the WBGS. Ideally, agreement should be reached that there will be an orderly and phased redemption of JD prior to introduction of a Palestinian currency; that is to say, agreement on a limit to the pace of depreciation of the exchange rate.

Mr. Abbott stated that he wished to support Mr. Shields's remarks on policy regarding the West Bank and Gaza Strip, and he also acknowledged the staff's efforts in helping the Palestine authorities to put together the framework for a sound macroeconomic policy.

Mr. Jonáš made the following statement:

One of Israel's major policy achievements in the 1990s was the absorption of a large number of immigrants. I understand from the staff paper that the successful absorption of the increased supply of labor was largely achieved by reliance on market forces. Unfortunately, the authorities seem to be less willing to rely on the same forces in other areas.

The deceleration of privatization is disappointing. I wonder whether the depression of the stock market is really as serious an obstacle as the authorities claim to the acceleration of privatization. If so, the planned distribution of vouchers should help to overcome it. Nor do I think the acceleration of privatization should be made to wait for progress with restructuring or the installation of an adequate regulatory framework. As to restructuring, there are several good reasons for leaving it to the new private owners, and as for the regulatory framework, it seems strange to claim that a market economy as well developed as Israel's lacks an adequate system for regulating the activities of private enterprises.

Of more immediate concern, however, are the signs of overheating. The authorities should not repeat 1993's mistake of prematurely easing monetary policy. Repetition of this mistake would introduce a damaging variability into the behavior of inflation, and under the current exchange rate policy it could also lead to appreciation of the real exchange rate and additional damage to the external position. Given Israel's already large current account deficit, any additional real appreciation resulting from overshooting the inflation target could seriously complicate the conduct of economic policy.

I agree with the authorities that the current account deficit does not present a financing problem for the moment, but as the staff point out, it is not sustainable. And the most recent figures on the trade balance show that onset of unsustainability can arrive sooner rather than later. The crucial question for policymakers is whether the surge in imports and accompanying deterioration of the current account are transitory or permanent. Unfortunately, for the present we can only speculate about the answer.

The surge in imports can be tracked partly to changes in consumption behavior. Consumption continued to grow strongly in the 1990s although the growth of real wages and savings was slowing. Since real wages were held down by inflows of new labor, it was possible to perceive the moderation of wage growth as merely temporary. Household accordingly would not feel it necessary to reduce their consumption. Under this optimistic scenario, the current account deficit is not necessarily a serious problem. But since the validity of this optimistic scenario is not clear, it would be unwise for the authorities to base their policies on it. It would be more prudent to base fiscal policy on the assumption that at least part of the widening gap between domestic savings and investment is permanent, and therefore has to be at least partly closed by increasing public savings.

Finally, one comment on capital inflows. The authorities explicitly recognize that capital controls do not work in Israel. In fact, Israel offers an important lesson that did not emerge at all during our recent discussions of capital inflows, and one which needs to be stressed. It is namely that as an economy becomes more open and sophisticated, capital controls lose their effectiveness. This is another strong argument supporting the claim that capital controls can at best be effective only temporarily, when an economy is still relatively closed and its domestic financial markets are not fully integrated into the world markets. The Israeli authorities deserve to be commended for explicitly recognizing these limitations. Their recognition of the limitations of capital controls also explains why the central bank puts such pressure on the government to rein in fiscal deficits. When capital controls cannot provide the glue for otherwise inconsistent monetary, fiscal, and exchange rate policies, these policies must become consistent. As Mr. Wijnholds says in his statement, in the longer run, monetary policy will be able to hold the line only if it is assisted by fiscal policy.

I wish the authorities success in facing the difficult challenges ahead.

Mr. Wei made the following statement:

The economic progress made by the authorities in achieving a high growth rate, while undertaking the challenging task of absorbing large numbers of immigrants, is, on the whole, commendable. However, the economic performance outcome as well as the effect of policy implementation stemming from immigration shocks gives cause for caution. Since we are broadly in agreement with the staff's appraisal, I would like only to emphasize the following points.

Although the 1994 figure of 14 percent inflation is lower than the previous year, it is still much higher than targeted. This phenomenon, as we understand, was induced by the previous easing of monetary policy in 1993, and, maybe more importantly, was due to the large wave of immigrants, as the first immigrants are now at the point of substantial consumption which has added to the demand pressure on the economy. However important this problem is, we are pleased to see that the authorities have set the priority of containing inflation in their policy mix and achieved some preliminary results. For example, the inflation expectation was successfully brought down by 3 percentage points in the first half of 1995.

Owing to the increase in the trade deficit, the current account deficit widened in 1994 and is expected to worsen further in 1995. On the other hand, the enlarged current account deficit, manifested by the sharp decline in private saving, is another discouraging factor for sustained economic growth. Although shrinking private saving primarily contributed to the shift in consumption behavior related to the wave of immigrants and could well be counted as a temporary factor, its damaging implications for the medium-term prospects should call for immediate vigilance on the part of the authorities.

In tackling these problems, we appreciate the decisive, sharp tightening of monetary policy in the fourth quarter of 1994, except for one concern, namely, the limits for monetary policy to take effect. Undoubtedly, the tightening of monetary policy aims at reducing inflation. However, given the extent of the openness of the Israeli economy, the widening interest rate differential between domestic and foreign assets resulting from an increase in domestic interest rates will bring constraints on the tightening of monetary policy owing to the offsetting impact of the subsequent large capital inflows. In this regard, we note that the authorities have succeeded in reducing domestic credit substantially and welcome their readiness to sterilize by intervention in the market.

On fiscal policy, it is encouraging to note that the Deficit Reduction Law has worked well in substantially bringing down the general government deficit, despite the huge fiscal burden of immigrant assistance and the tax reduction program. While this success has undoubtedly benefitted from tight expenditure control, strong economic growth is also an important factor. However, the public debt/GDP ratio, although somewhat reduced, is still maintained at a level as high as 92 percent. Therefore, it is in this area that more ambitious steps should be taken to increase the strength of fiscal consolidation.

We very much appreciate the authorities' view that privatization should be preceded by adequate regulations and their cautious attitudes in handling the pace of privatization, in view of the lessons we have learned from many countries undergoing important systemic changes. In this regard, the authorities should be encouraged to achieve an appropriate structural policy mix in a balanced and coordinated manner.

In conclusion, the Israeli economy has, on the whole, performed well. The authorities' policy responses have been commendable. However, the high rate of inflation and the widening of the current account deficit, accompanied by the sharp decline in private saving, are causes for concern. It is our sincere hope that these problems will call for sufficient caution on the part of the authorities so that they can be brought under control before having a medium-term impact. Finally, the authorities are encouraged to find a balanced way to solve their problems, and we wish them every success in their future endeavors.

Mr. Kannan made the following statement:

The Israeli authorities deserve our full commendation for their remarkable achievements in many strategic areas. It is impressive that such a high number of immigrants have been absorbed, while at the same time unemployment has been reduced to 7.8 percent in 1994, from 11.2 percent in 1992. Equally significant, the economy's growth rate of 6.5 percent in 1994 compares highly to 3.4 percent in 1993. The 1994 budget deficit turned out to be much lower, at 1 percent of GDP, than the target of 2.2 percent of GDP. We are happy to note from Mr. Wijnholds's statement that the 1995 budget deficit target is achievable. The significant reduction in the public debt to 92 percent of GDP in 1994 is also worth noting.

But in order to sustain these achievements in a durable manner, the authorities must be vigilant and initiate necessary steps to bring down inflation on a priority basis. In spite of the favorable fiscal position, comfortable foreign exchange levels, and abeyance of the liquidity overhang, consistent inflation reduction is yet to be seen.

From the staff paper, one gets an impression that the preponderant portion of inflation is structural in nature. Hence, it is not clear to what extent monetary policy could be further burdened to meet this objective. Durable fiscal deficit reduction will alone help monetary policy to attain the inflation reduction. We share the view that the effectiveness of monetary policy had been undermined by the substantial borrowing by domestic residents in foreign currency. Although the authorities have succeeded in sterilized intervention, continuation of this trend that would no doubt put strong pressure on interest rates, in addition to a sharp increase in net external liabilities, need another careful look. However, the staff paper does not spell out the strategy proposed to handle this issue of borrowings.

We agree with the staff that improving private savings might contribute to the reduction of the current account deficit, but this will take considerable time if we go by the experience of other developing countries. Hence, some short-term measures are in order to address this issue of current account deficit reduction. In this respect, given the importance of investment development, to what extent imports could be curtailed is not clear. Furthermore, whether the present exchange rate band is sufficient or some more modification is required is yet another issue. Although the comfortable foreign exchange reserve position offers no problem to the financing of the current account deficit, a cautious approach must be followed. Furthermore, in 1995, short-term capital inflows are projected at about 55 percent of total capital inflow. Given the high current account deficit, the authorities may exercise utmost caution in attracting short-term capital of this order

May I request the staff to explain the following. In Table 1, page 3, although the overall output growth forecasts for 1995 are almost the same, for the staff and for the authorities, the components are considerably different. It is not clear whether this has contributed to any differences in policy prescription. Secondly, with reference to the medium-term balance of payments projection given in Appendix II under the alternative scenario, to what extent will the reduction in imports curtail investment in the economy, and there why is there no mention of the inflationary impact of the depreciation, which the staff has projected. With these comments, we wish the authorities success in their endeavors.

Mr. Desruelle made the following statement:

Previous speakers have presented a consensual view of developments in Israel and I will not break that consensus. I agree that economic management of the authorities over the past years have made possible remarkable achievements, particularly on the integration of immigrants, on growth and unemployment, and on progress on the fiscal front. I agree that the recent evolution of inflation and the current deficit have not been quite so satisfactory.

I would welcome the views of the staff on whether the inflation target has been, in and of itself, particularly helpful in the conduct of monetary policy and the transmission to the public of the expectations of the monetary authorities. Judging from Chart 6 in the background paper on recent economic developments, it is not obvious that, at least in 1994, the target influenced either policy conduct or inflationary expectations. Given the current situation, I agree with previous speakers that the tightening of financial policies is desirable, and I find extremely convincing the argument of the staff and previous speakers that fiscal action--in particular on the expenditure side--is the best way to go to achieve this macroeconomic tightening.

At present, the authorities seem to have chosen another route, sort of the "second best" mentioned in the staff appraisal, which is giving more flexibility to monetary policy through an appreciation of the exchange rate in the band. This is an approach that, combined with a tight monetary stance and perhaps a further widening of the band or some other modifications along the lines mentioned by Mr. Shields, may work in reducing inflation further. In some ways, this policy mix has some of the flavor of the mix of policies followed in the United States in the early

1980s, and we know that that succeeded--at some cost in reducing inflation. However, the cost of using this approach alone, in terms of competitiveness of the economy and of imbalances in the external account, should not be underestimated. The economy could be left highly vulnerable to external shocks, and unforeseen events might then force the authorities to undertake macroeconomic tightening in much less favorable circumstances than today.

Let me add three remarks regarding the West Bank and Gaza Strip. My authorities wish to express their deep appreciation to the staff for the work done both on technical assistance to the Palestinian authorities and on economic analyses of the situation in the West Bank and Gaza Strip. With this case, we have the proof that, even without financing, the Fund can be extremely helpful in a post-conflict situation through the provision to all parties concerned, including the World Bank and donors, of a coherent economic framework. With this coherent framework, others are then in a position to structure efficiently their operations and financing. Finally, my authorities remain extremely concerned that illustrative medium-term macroeconomic scenarios indicate limited prospects for a resumption of growth. They indeed view sustainable growth as a key element for lasting peace in the region.

The Deputy Director of the Policy Development and Review Department, considered that privatization had been proceeding far too slowly. However, there were legitimate reasons for delaying privatization sales. The stock market, after having been one of the most buoyant of the emerging markets of the early 1990s, had fallen by approximately 40 percent since February 1994. That crash mandated caution before bringing more corporations into the market. The authorities had also pointed to the imprudence of privatizing companies that would have a monopolistic position without first introducing an adequate regulatory framework and before undertaking necessary structural reforms. Nevertheless, in light of the fact that the process of privatization had been under way since 1985, more progress was to be expected.

Israel had been liberalizing capital inflows and outflows, the Deputy Director stated. There were no restrictions on inward capital movements, and companies could borrow abroad both in the short and long term. On the outflows side, there remained certain regulations that prevented institutional investors from committing too large a proportion of their assets abroad. However, substantial progress had been made in that area in the preceding few years.

The staff had suggested to the authorities the possibility of implementing controls on inward capital movements similar to those used in Chile, the Deputy Director noted. The authorities had remarked that, given their experience in the late 1970s, such capital controls were not an advisable measure and could create leakages and distortions in their highly open and integrated market.

Agreeing with Mr. Shields, the Deputy Director stated that fiscal policy was a matter of concern and that a stronger call for tightening in public sector savings would be appropriate, particularly given current developments. There were many indications that the economy was at or beyond its potential, and private sector saving was declining. The budget proposal for 1996, which was seeking barely a quarter of a percentage point of GDP improvement with respect to the domestic deficit in 1994, would put severe strains on monetary policy. Because there were limits to the independence of monetary policy under is exchange rate system, Israel had widened the diagonal exchange rate band from 5 percentage points to 7 percentage points. More tellingly, it had been using the more appreciated part of the band, and the exchange rate was now 4 percentage points above the midpoint. While appreciating the exchange rate could help on the inflation side, it could also lead to balance of payments problems later. A better solution would be to support the monetary policy with sound fiscal action.

Israel's inflation targeting had been an important departure in policy from the preceding years, the Deputy Director stated. The introduction of the diagonal exchange rate system was intended to provide an anchor, and accompanying it with an inflation target was helpful in policy formulation, particularly in a country where there was little support for progressively lowering the inflation rate. Moreover, the policy at the Bank of Israel was shifting toward looking at the inflation target as the ultimate objective. The inflation target of 8-11 percent for 1995 appeared attainable because of low fruit and vegetable prices and the effects of the behavior of the exchange rate of the dollar on housing prices. However, with inflation picking up, there was reason for concern both in setting and meeting the inflation target for 1996.

The staff had found that the domestic components of aggregate demand were very strong, with consumption and investment in the first half of 1995 running at 10 percent above their corresponding levels in the preceding year, the Deputy Director observed. Both the authorities and the staff were estimating that potential output could be growing at about 5 percent, but the staff's view was that, given the strong domestic demand and limited domestic supply, a higher current account deficit than that projected by the authorities would be inevitable; the staff predicted it at 7 percent of GDP, while the Ministry of Finance predicted it at somewhat below 5 percent of GDP.

Mr. Kannan noted that, because capital goods constituted a large part of imports, a decline in overall imports might have implications for domestic investment. He wondered what the impact of a depreciation would be on inflation.

The Deputy Directory of the Policy Development and Review Department commented that the staff was calling for a fiscal tightening that would have the effect of allowing the Bank of Israel to have lower interest rates and a more depreciated currency. The resultant cooling of the economy would slow down the rate of imports, while lower interest rates would improve the chance that investment could be maintained at a reasonable level that would allow for growth. Essentially, the staff's alternative scenario was looking for more balanced policies that would allow the current account to be corrected as well as for investment to be maintained.

Mr. Schoenberg made the following statement:

Israel's recent economic performance has indeed, in many aspects, has indeed been very impressive. In my view, Israel's most remarkable achievement over the last years has been the integration of the huge number of immigrants. The authorities deserve special commendation, since this difficult task was achieved, as mentioned by Mr. Kannan, without a deterioration in public finances and an improvement in the unemployment situation. Rather, the fiscal position has improved by some 5 percentage points of GDP over the last 5 years. It is also in the case of Israel quite instructive to observe that in spite of, or I should rather say because of, a significant withdrawal of fiscal stimulus, growth has been remarkably high over the last years.

Notwithstanding the overall quite favorable position of the Israeli economy, policy makers are facing a number of challenges. In the short run, the authorities' main preoccupation--as just confirmed by staff--should focus on avoiding an overheating of the economy. For this purpose, it is crucial to continue the hitherto prudent fiscal policy. I share staff's view, that the budget target for 1995 is not ambitious enough. The projected relative fiscal relaxation in 1995 appears to run not only against the background of high economic activity but also the still large overall public debt.

Another important task is the intensification of efforts aimed at making the economy more flexible. In this area, progress has not been fully satisfactory in the past. Of particular importance, in my view, are the privatization of public enterprises and a further restructuring of the banking system. Mr. Jonáš made some interesting remarks on that issue.

As staff has, in our view, identified correctly the measures necessary for tightening fiscal policies and for structural reforms I will make only a few short remarks on the monetary and exchange rate policy.

In late 1991, the authorities adopted a "diagonal" exchange rate policy system in order to reduce inflationary expectations by providing a nominal anchor for the economy which was later complemented by the announcement of specific inflation targets for the year ahead. It appears to me that monetary policy in Israel is not overburdened as alluded to by some speakers but rather somewhat confused by the messages received from two different indicators. While the staff report states that the overriding objective of monetary policy must be to meet the government's inflation target, it is not clear to me how this objective can be safely attained, if the Central Bank follows at the same time an exchange rate objective (called by Mr. Wijnholds a "managed float"), particularly under conditions of strong capital inflows. To my mind, the relationship between the exchange rate and the inflation rate is not so tight that the authorities could aim at both objectives without risking that the attainment of one could mean failure to reach the other one and vice versa. I also think that Mr. Lachman's earlier explanation that the exchange rate gives "some kind of signal" is somewhat at variance with the character of an anchor (which is one expression used in the staff document).

The situation is further complicated by the fact that the exchange rate objective is defined as keeping the exchange rate within a certain band and both the location and the width of the band are adjusted from time to time in a discretionary fashion. If on the other hand, rather the actual inflation rate is used as the operational guide for monetary policy as suggested by Mr. Wijnholds in describing how the Central Bank took corrective action when it realized that actual price developments exceeded the 1994 inflation target by a wide margin, then one wonders how effective such an approach can be given the usual time lags involved when taking monetary policy measures. In our view it is important that monetary policy has a clear and unambiguous guidance.

As there are limits to which sterilization operations have a lasting effect without distorting factor-allocation the prospect of continued strong capital inflows would appear to argue for a more flexible exchange rate policy in order to keep the inflation target operational, i.e. the exchange rate band would become obsolete. Any resulting competitive problem would necessitate, however, counterbalancing measures, particularly increased public and private saving.

The Deputy Director of the Policy and Review Department, agreeing with Mr. Schoenberg, stated that more attention had to be given to the inflation target instead of trying to keep the exchange rate at a particular level. Monetary policy must be aided by an adequate fiscal policy. However, given Israel's recent experience with hyperinflation, the possible usefulness of an anchor should be kept in mind. While the current pressure was toward appreciation, the situation could reverse itself and some exchange guidance could be useful.

Mr. Schoenberg remarked that, to the extent that the exchange rate was allowed to appreciate, the supporting role of fiscal policy would be less urgent. However, it appeared that the confusion regarding monetary policy extended into the area of terminology. The Deputy Director of the Policy and Review department had stated that the exchange rate was supposed to give some sort of signal to the monetary authorities, and that that was different from a monetary anchor. It was unclear how much weight was to be given to which signal under which circumstances.

The Deputy Director of the Policy Development and Review Department observed that the policy in that respect was evolving. He recalled the unfortunate episode in 1993, when monetary policy had been loosened too much and interest rates had been brought down too sharply--even though there were no particular problems with the exchange rate--resulting in a substantial breach of the inflation target for 1994. As a result, more attention was being paid at present to the inflation target than to the maintenance of the exchange rate parity.

Mr. Coumbis made the following statement:

The performance of Israel's economy has been excellent in many areas since 1990. Thus, the authorities were able to achieve high real GDP growth, a reduction of inflation, a consolidation of public finances, and a lowering of the debt-to-GDP ratio. The area where the achievement of policy was most striking was the absorption of 600,000 immigrants (approximately 13 percent of the population) in the active labor force, coupled with a reduction of the overall rate of unemployment to pre-immigration levels.

Moreover, there is no doubt that the long-awaited peace in the region will improve substantially Israel's economic performance by contributing to the a significant reduction of military expenditure and improved business sector confidence in the economy's prospects.

However, the Israeli economy has some problems. Private sector savings have decreased since 1992 and the external current account deficit increased substantially in 1994 and 1995. Furthermore, the 1994 reform process has slowed, especially in the area of privatization. There are also specific problems connected with the 1995 budget, capital inflows, and pension system reform. Since I am in broad agreement with the staff's analysis, appraisal, and suggestions, I will limit my remarks to a few points for the sake of emphasis.

There is no doubt that considerable progress has been made in past years towards reducing the budget deficit and the debt-to-GDP ratio. However, for the 1995 budget, domestic and external policy targets as a percentage of GDP were set at a level higher than the 1994 budget's actual outcome. Moreover, there were some indications that recently there have been substantial shortfalls in revenue collection, while there may be pressures to increase budgetary expenditures in 1995 because of expected elections in 1996.

I agree with the staff that the more efficient way to face the increasing external current account deficit and declining private savings is to increase public sector savings. The best way to do this is by decreasing public expenditure in the areas of public sector wages and employment as marginal tax rates and the tax burden are very high. In that respect, I support the staff's suggestions to achieve an overperformance on the 1995 deficit target and to increase substantially the 1996 targets for public sector savings. These policies will also contribute to the further decrease of the still-very-high debt-to-GDP ratio. Fiscal consolidation, along the lines suggested by the staff, will help the authorities to face more efficiently the problem of short-term capital inflows.

With respect to pension reform, there is no doubt that without these reforms the actuarial deficit of the existing pension fund would have widened further. I can see the staff's points that the reform did not go very far and that it reversed, to a certain extent, major capital market reforms of the last decade. Moreover, there is the problem that the Government has assumed responsibility for the funding of large long-term pension obligations and this, of course, is one more reason for requiring further substantial consolidation of Government budgets. However, I have some sympathy for the authorities' arguments that this reform was an important step forward and one that would make the public more conscious of the system's grave condition.

With these remarks, I wish the authorities every success in their efforts.

Mr. Kang made the following statement:

As appropriately noted by previous speakers and the staff, tasks currently facing the Israeli economy could be summed up as lowering the inflation rate, reducing the current account deficit and raising private savings.

Achievement of these objectives would require a carefully thought-through policy mix.

Leaving aside the question of what the optimal policy arrangements might be, I would like to agree that under the present circumstances, to contain inflation and reduce the current account deficit, there seems to be a limit to further tightening on the monetary side and therefore a far greater burden should be shared by the fiscal side than currently envisioned by the authorities.

That is, excessive tightening of the monetary policy would be undesirable nor would it be possible under the present crawling peg exchange rate regime. Two reasons:

Considering the relatively large interest rate differential between the domestic and Euro markets, excessive tightening would result in a further increase in short-run capital inflows that would tend to expand domestic liquidity and result in heavier upward pressure on the currency regime. The tightening through interest rates could have some positive effect on private savings but such a proposition is always certain.

Furthermore, in order to benefit from the stabilization effect of the current crawling peg exchange rate regime that views the exchange rate as a "nominal anchor", too much discretion in the implementation of monetary policy should be avoided wherever possible.

On the other hand, further tightening on the fiscal side, if possible, would be relatively free of these pitfalls and the effect would be much more direct, especially on savings. In this regard, overperformance of the 1995 budget should be strived for. Considering the relative buoyancy of revenue prospects for the year and that large delayed recurrent expenditure has already been incurred last year, such a prospect seems quite bright.

I agree with the staff's recommendation that to deal with the recent sharp increase in short-term capital inflows the sterilization policy through open market sales of domestic bonds be used in combination with a more restrictive discount policy, i.e, the monetary loans to the commercial banks.

However, there are practical limitations to the use of the classic sterilization policy: a deterioration in the fiscal position of the central bank and the rise of domestic interest rates which may attract additional capital inflows.

Thus, the authorities could benefit from considering the use of other supplementary sterilization measures, by utilizing the lessons we learned at our International Capital Markets discussion, particularly to discriminate selectively the short-term capital inflows in a relatively less distortionary way.

The practical advantages of this indirect control measure are also witnessed by the recent discussion on Chile.

One last comment. If we look at Chart 6, we could readily acknowledge that the gap between merchandise imports and exports is starting to widen. It may not be consistent with the Fund's market economy doctrine, but I feel that industrial policy to support the manufacturing sector might be considered for long-term stability. I would appreciate the staff's view on this point.

Mr. Ruocco made the following statement:

Staffs papers point out clearly not only the success achieved by the Israeli economy, but also its main difficulties and challenges ahead, in spite of the relatively strong and promising economic growth over the medium term.

Because I am in general agreement with the staff appraisal, I will only emphasize the following points.

First, in spite of the fact that the Israeli economy is expected to continue growing at a good pace, we believe that some improvements in its economic policy are needed to guarantee a sustainable and healthy economic growth in the medium and long term.

Second, along these lines, the authorities should be more ambitious in the fiscal area in order to cut fiscal deficit, mainly by controlling and reducing fiscal expenditures. In this respect, the 1995 and 1996 fiscal stance seems to be not too ambitious, particularly in light of the fact that recent improvements in fiscal revenues are not expected to continue, and additional pressures seem to exist to adjust fiscal expenditures upward.

Third, improvements in the fiscal area will produce important benefits not only in easing the burden carried by the monetary policy, but also in avoiding additional inflationary pressures and high interest rates, at the same time of promoting the private sector savings ratio, particularly because some signs of overheating seem to be present in the economy. Regarding the savings ratio, while I agree that structural changes are involved in its current decline, I also agree with Mr. Murphy in the sense of countervailing actions on the fiscal front are currently needed to succeed.

Fourth, stronger actions are also needed in the area of structural reform; on the one hand, on the privatization program, which has been stalled. However, like Mr. Murphy, I also concur with the authorities in relation to their desire to put in place an appropriate regulatory framework prior to privatization in certain cases, at the same time that urgent actions should be taken to accelerate the whole process. On the other hand, efforts made by the authorities in reforming the pension system should be recognized. However, it is clear that this reform falls short of what would be desirable from a longer-term perspective. In any case, this pension system will impose a heavy burden on future budgets, which call for stronger efforts in consolidating the fiscal area. Further reforms in the pension system seem to be less realistic in the short term.

Finally, we wish the Israeli authorities every success in their economic process, and encourage them to take advantage of the current conditions to introduce or strengthen the measures needed.

Mr. Desruelle noted the concern of his authorities regarding the limited prospects for growth in the scenarios for the West Bank and Gaza Strip. He wondered what was behind those worrisome forecasts, and about the most effective actions that could be taken to ensure that growth would be significantly better.

The staff representative from the Middle Eastern Department said that there were four key factors affecting growth in the West Bank and Gaza Strip. The first was the availability of private savings. Available private sector savings had diminished significantly since 1992 and those available were probably not sufficient to sustain private sector investment by themselves. The construction sector, however, had benefitted from some transfer of private capital from abroad. A second factor was the availability of new flows of income. Those depended in part on an increase in domestic income and on whether the sharp decline in workers' remittances would continue. A third factor was the capacity of the West Bank and Gaza Strip to import and export, which would influence the sustainability of the public sector investment program and determine whether or not the private sector would have the capacity to import key inputs which were simply not available domestically. A fourth factor was private investor confidence, which was related to uncertainty regarding security, the likelihood that the borders would remain open, and the development of a regulatory framework.

The amount of public sector investment capital needed was probably twice the current amount, the staff representative continued. The World Bank, together with the Palestinian authorities, had put together a three-year public sector investment program. The success of that program would depend upon quick disbursement of the World Bank loan and the success of the employment creation project in reducing unemployment, generating domestic income, and increasing private saving. The Palestinian authorities needed to improve the absorptive capacity of the economy through progress on fiscal expenditures and tax administration, on promoting a sound banking and financial system, and on developing a sound medium-term development strategy.

Overall, the achievement of a high rate of growth would require an improvement in the security situation, a clearer definition of the institutional responsibility of the Palestinian Authority, and on more favorable perceptions on the part of both domestic and foreign investors, the staff representative said. However, it needed to be borne in mind that, even if the overall environment improved, it would still be difficult to avoid a deterioration in per capita consumption over the following three or four years, given the high unemployment level and the high rate of population growth.

If the Palestinian Authority continued to follow reasonably tight fiscal restraint, and if the tax base continued to widen, there was hope that the external financing currently needed to cover the current account deficit could be phased out over the coming few years, the staff representative observed. That would free up more available resources from abroad to finance investment. Together with enhanced private confidence, that could help achieve an improved level of real growth over the medium term in the West Bank and Gaza Strip.

The Acting Chairman asked whether industrial policy to strengthen the manufacturing sector might be a useful way to help narrow the current account deficit.

The Deputy Director of the Policy Development and Review Department said that Israel did not have a formal industrial policy, although it did provide a limited amount of subsidization for investment in research and development for high-technology industries. However, the problem with the current account deficit did not seem to be on the export side, which had shown great dynamism precisely in high-technology exports such as telecommunications, computer software, and agribusiness over the preceding few years. Rather, the problem seemed to be an overheating of the economy.

Mr. Wijnholds expressed his appreciation to Directors for their interventions and assured them that they would be faithfully conveyed to the Israeli authorities. He agreed with Mr. Shields that Israel was dealing with the problems of success. The conclusions of the staff report had been widely debated in the Israeli press. On the question of the exchange rate regime, he encouraged the Acting Chairman to invite Mr. Schoenberg to the roundtable discussions planned with the Governor of the Bank of Israel at the time of the Annual Meeting.

The Acting Chairman made the following summing up:

> Directors commended the Israeli authorities for the policies that had led to the impressive rate of economic growth since the large wave of immigration began in late 1989, and for the successful absorption of most of the new immigrants into the domestic economy, while at the same time reducing the overall unemployment rate. They also welcomed the fact that growth prospects had been enhanced by the peace process. Directors observed that, although compared with past trends, there had been a favorable fiscal turnaround in recent years, the decline in private saving meant that stronger efforts at fiscal consolidation were still needed.

Directors expressed some concern about the recent overheating of the economy, particularly as manifested in a substantial widening of the external current account deficit that was accompanied by a marked decline in private savings. While Directors considered that the current account deficit did not pose an immediate financing problem, they emphasized that the present level of the deficit could not be sustained and that its early reduction was required.

Directors considered that the key policy challenge in the period ahead was to strengthen the level of domestic savings. Given the uncertainties surrounding private savings behavior, Directors emphasized that fiscal policy would need to play a crucial role in that effort. In this context, they considered that a more ambitious fiscal effort than presently envisaged was needed, and that public expenditures would need to be tightly controlled, particularly in the realm of public sector wages and employment. As regards 1996, Directors stressed that the budget should aim at significantly increasing national savings. This was required not only for balance of payments reasons, but also to reduce Israel's level of public debt, to meet the Government's future pension obligations, and to prepare for any future reduction in unilateral transfers.

Directors welcomed the changes that had been made in the direction of reforming the pension system, but noted that--barring further reform--the pension system would impose a heavy burden on future budgets. Some Directors criticized the present plans for pension system reform as being inadequate and called for more comprehensive reforms, including moving toward a fully-funded pension system for public employees.

Noting the disappointing price performance in 1994, Directors stressed that the overriding objective of monetary policy must be to meet the Government's inflation target in 1995 and to lay the basis for a further decline in inflation. In this context, Directors cautioned against a premature reduction in interest rates.

Directors generally considered that the diagonal exchange rate band system had served Israel well. However, they observed that the recent implementation of monetary policy had been complicated by a surge of short-term foreign borrowing by Israeli companies. While the Bank of Israel had successfully sterilized these inflows to date, the cost of such sterilization could not be overlooked. Directors noted that these considerations made it all the more necessary that more of the burden of macroeconomic stabilization should be transferred to fiscal policy through the implementation of a more restrained fiscal stance. Some Directors noted the limits for monetary policy to attain simultaneously both the inflation and the exchange rate objectives, especially in the face of large capital inflows. They encouraged the authorities to reassess exchange rate policy, including making greater use of the more appreciated part of the exchange rate band. They warned, however, that if further fiscal restraint were not forthcoming, the authorities would be faced with the choice between allowing further exchange rate appreciation--with the attendant risks of a further widening in the current account deficit--or accommodating capital inflows, with the likelihood of increasing inflation.

Directors were of the view that aggregate demand policy in Israel needed to be complemented by a reinvigorated supply side approach. Regretting that the privatization process had stalled, they supported the Government's recently proposed option scheme and urged its early implementation. In particular, they urged a faster pace of bank privatization.

Directors welcomed the opportunity to review recent economic developments in the West Bank and Gaza Strip and to assess the progress being made in institution building. They also welcomed the Fund's increased involvement in providing technical assistance to the Palestinian Authority in the areas of fiscal policy, monetary and financial management, and the improvement of the macroeconomic statistical base. They considered that the main emphasis of a development strategy for the West Bank and Gaza Strip should be outward oriented and private sector led, particularly in view of the large investment and employment needs. Moreover, they attached the highest importance to the establishment of sound and transparent public finances in the West Bank and Gaza Strip.

It is expected that the next Article IV consultation with Israel will take place on the standard 12-month cycle.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/95/87 (9/14/95) and EBM/95/88 (9/15/95).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/149 (9/13/95) is approved.

APPROVAL: May 8, 1997

REINHARD H. MUNZBERG
Secretary