May 7, 2001
Approval: 5/14/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 99/28

10:00 a.m., March 17, 1999

Contents

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
	K. Kpetigo, Temporary
T.A. Bernes	
R.F. Cippà	W. Szczuka
B. Esdar	W.-D. Donecker
	A.G. Zoccali
	M. Pérez, Temporary
	J. Spraos
	A. Giustiniani, Temporary
	L. Pinzani, Temporary
	E. González-Sánchez, Temporary
K.A. Hansen	O.-P. Lehmussaari
K.-T. Hetrakul	C. Harinowo
W. Kiekens	S. Zádor, Temporay
K. Lissakers	B.S. Newman
	S.D. Melese-d'Hospital, Temporary
	R. Fernandez
	M. Daïri
	S. Rouai, Temporary
	Y. Patel, Temporary
	A. Lushin
S. Pickford	S. Collins
	H. Mori, Temporary
	W.F. Abdelati, Temporary
M.R. Sivaraman	A.G. Karunasena
	R.P. Watal, Temporary
G.F. Taylor	O. Kwon
	I.-K. Cho, Temporary
Wei Benhua	
	Y.G. Yakusha
	I.C. Ioannou, Temporary
	H. Ogushi, Temporary

A. Linde, Acting Secretary
A. Mountford, Acting Secretary
K.G. Fitchett, Assistant
P.J. Kunzel, Assistant

Also Present
IBRD: A. Bhattacharya, Poverty Reduction and Economic Management Network Office; S.-Y. Song, East Asia and Pacific Regional Office. Asia and Pacific Department: Y. Horiguchi, Associate Director; S. Cook, K. Ishi, E. Jafarov, R.P. Kronenberg, I. Otani, T.R. Rumaugh, H. Shishido. European II Department: M. Farahbaksh, O. Havrylyshyn, M. Shadman-Valavi, L.M. Valdivieso. External Relations Department: M.W. Bell, R.W. Russell. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; R.B. Leckow, I. Mouysset. Monetary and Exchange Affairs Department: M.Y. Khamis, R. Morales, M.G. Quintyn. Policy Development and Review Department: J.T. Boorman, Director; M. Allen, Deputy Director; T. Leddy, Deputy Director; J.D. Charap, M. Fisher, R.B. Kahn, I. Kapur; G.R. Kincaid, L.Y.M. Leigh, C.G. Muñiz, A. Mazarei, L. Nielsen, D.J. Robinson, T. van der Willigen. Research Department: M. Mussa, Economic Counsellor and Director; M. Minovi, A.K.H.G. Swoboda. Secretary's Department: P. Gotur, B.A. Sarr. Treasurer's Department: T.M. Mast, A.B. Westphal. Western Hemisphere Department: A. Barajas, R.K. Rennhack. Office of the Managing Director: E. Brau, D. Citrin. Advisors to Executive Directors: M. Askari-Rankouhi, B. Couillault, M.H. Elhage, N. Jadhav, J. Jonáš, Luo Y., M.F. Melhem, S. N'guiamba, J. Ntamatungiro, L. Palei, E. Rodriguez, O. Schmalzriedt, M. Sobel, I.M. Woolford. Assistants to Executive Directors: A.S. Alosaimi, S.A. Bakhache, N.R.F. Blancher, K.S. Brownlee, R. Burgess, M. Carlens, H.W. Cocker, K. Gobe, H. Hagan, M.R. Hajian, C. Josz, A. Kapteijn, S.K. Keshava, D.H. Kranen, K. Lai, Lu A., D. Nardelli, J. Nelmes, Peh K.H., M.M. Salvador, R.J. Singh, Siti Mariam Mohd. Yusof, Vongthieres O., I. Zakharchenkov.

1. FORESTALLING AND RESOLVING FINANCIAL CRISES—INVOLVING PRIVATE SECTOR—FURTHER CONSIDERATIONS

The Executive Directors considered a staff paper on further considerations in involving the private sector in forestalling and resolving financial crises (EBS/99/21, Rev. 1, 3/9/99). They also had before them a background paper (EBS/99/29, 3/5/99).

Mr. Sivaraman submitted the following statement:

The involvement of the private sector in forestalling and resolving crisis is to the mutual advantage of the private sector and the other parties concerned. If private sector acts with restraint and does not panic in the nascent stages of a crisis, perhaps its exacerbation and contagion could be prevented long enough to give sufficient time to the authorities to adapt policies in consultation with the Fund to restore normalcy.

There has been so far no satisfactory identification of the trigger that started the crisis. But there is no room for doubt that when the private sector panicked and made rapid exits to cut their losses, they deepened the crisis and their losses probably increased. Therefore, private sector has to be involved. The way in which it is now cooperating in Korea, Thailand, Indonesia and Brazil by rolling over credits and agreeing to maintain the credit line is a sufficient indication of its importance in maintaining the stability of the international monetary system.

Regarding specific issues, our comments are as follows:

(a) We agree that prevention is the key and hope that the membership of this institution will agree sooner rather than later, to an amendment to the Articles of Agreement binding them to follow certain minimum standards in all the identified areas. This chair had suggested this on earlier occasions and would like to reiterate it so that there is no ambiguity on this issue. We will revert to this subject while discussing the paper on International Standards.

(b) We believe that any standstill arrangement or moratorium on payments should be only as a last resort and subject to the IMF supporting it. On resorting to exchange controls, this chair would prefer price or tax based measures rather than retracing the path a country has traversed in freeing its economy from exchange controls.

(c) As regards contagion, this chair is of the view that it will strike countries which are overexposed in terms of external debt, especially on the shorter end of the market and when there is a fear of its not being able to generate enough foreign exchange to pay for its obligations when falling due. Countries that have full convertibility or those which are moving toward it have to watch their debt profile and the ability of its corporate and banking sectors to discharge liabilities. Suitable monitoring mechanisms require to be designed even if it involves reduced inflows.

(d) Table 1 on the progress of identified measures is very useful. As there may not be a unique solution that can fit all countries in dealing with crises, it may be necessary to arrive at a definite assessment on how each of the proposals in the Table could be used should an occasion arise.

To elaborate further, on preventive measures, countries that have capital account convertibility require to:

(I) closely monitor movements in foreign exchange reserves and publish them periodically for public knowledge.

(ii) keep a careful watch on interbank borrowings and the application of short-term funds. Short-term interbank borrowings could be made more expensive with increasing amounts. Bank specific monitoring mechanisms have to be devised and bank supervision should examine this aspect regularly.

(iii) monitor external borrowings of the corporate sector. While being subject to private regulatory mechanism (like credit rating, project appraisal and so on)., this did not prevent excessive borrowing and bad investment decisions in South East Asia. Companies should be required to report their external debt position regularly with the audit making a specific comment on the ability of the company to discharge its liabilities. India has had an annual cap on external commercial borrowing and only companies with strong balance sheets contract external debt. In this, private sector has to regulate itself - both the lender and the borrower and the country's central bank or the debt-monitoring authority should closely monitor it.

(iv) while the word "control" is anathema to a market worshiper, if there has to be discipline, there has to be a rule based mechanism by whatever name it is called, to ensure what staff has suggested in para 12. Even traffic in freeways has to obey some rules. What these rules could be, how self-regulatory they can be, who and how can their observance be monitored and what penalties can be attached to defaults have to evolve over a period of time through discussions in the IMF and other fora.

As far as contingent lines of credit are concerned, the crux of the problem has been clearly brought out by the staff, viz., "to what extent lenders would be prepared to provide this type of financing to a broader range of market participants or how best to address concerns of moral hazard to the extent that the country can affect the conditions under which a line can be exercised" remains unclear (para 19, p. 12).

A country which has a large exposure to external credit may not find enough lenders to provide a sufficient contingent line of credit or it may come at high cost. Staff does not seem to prefer a call option for the fear that exercising this option might trigger other undesirable consequences. The same could be equally valid in the case of a country deciding to draw upon a contingent line of credit. While sovereign borrowers should consider these two with caution, individual corporate borrowers could consider it in their arrangements with lenders.

It appears from staff's own assessment that structured notes have problems. The examples of guarantees by the World Bank in the case of specific loans do not indicate that it can be put to widespread use.

While the staff has pointed out the difficulties and dangers in negotiating roll overs, there may be little option both to the lenders and the borrowers in a situation where without a roll over, there could be a default unless the Fund or other support is available to meet the capital outflows.

The need for having transparent and legally enforceable bankruptcy laws require no emphasis. More than having appropriate laws, court procedures require to be simplified for speedy decisions. This may not be the case in many countries where protracted court procedures defeat the purposes of the law.

We agree that sovereign bonds should be more of the British style and should contain sharing clauses, modification of terms by qualified majorities and collective representation provision. It is inevitable that inclusion of these clauses will increase the cost of borrowing. But it may still be a small price to pay to avoid future problems.

Earlier, I had doubted the efficacy of having a provision in the Articles of Agreement enabling the Fund to sanction a temporary stay. While there are merits to having such a provision, it could be more ornamental than useful. In the event of a large scale crisis, Fund will not be in a position to resort to this situation as it will only worsen the crisis. If a single country or a very small number of countries get into payment difficulties, invoking this provision could provide breathing time to adapt policies or have debt work outs. Enforcement of this provision may deny the countries access to market for a long time. Therefore, this remedy has serious hazards.

In conclusion, we believe all the measures have their advantages and disadvantages. It may be difficult to codify them for use under crisis situations in a particular manner excepting those that directly concern the Fund like lending into arrears or the use of special facilities.

Mr. Yoshimura and Mr. Ogushi submitted the following statement:

Mr. Bernes submitted the following statement:

The international community has clearly arrived at a consensus on the need for a greater involvement of the private sector in the prevention and resolution of financial crises. The reasons for this consensus are well known and have been discussed extensively on numerous occasions at this Board and in other fora, and I will not repeat them here.

However, there may be some difference in views on what the requirements may be for private sector involvement. The staff seems to suggest that (paragraph 2) involving the private sector in the resolution of financial crises would require large official financing. I would argue that if the international community reaches an agreement on some of the measures that are discussed in the staff paper, the private sector can be bailed in and a wide-spread crisis can be averted with the official sector playing the role of honest broker, advisor and financial catalyst, and not necessarily the provider of large financing. In fact, there is little evidence that large official financing has been a key factor in resolving some of the recent crises. The policy adjustments and the involvement of the private sector, through moral suasion or otherwise, appear to have played a more prominent role than official financing in the crisis countries that have reached some degree of stability (Korea, Thailand and hopefully Brazil). This is a fundamental issue in the context of the role of the IFIs, especially the Fund, in the resolution of financial crises, which needs to be discussed. Comments from the staff would be appreciated.

Prevention

There is no doubt that the international community should focus first and foremost on prevention. Creating an effective and transparent policy and regulatory environment and improving the flow of information will help private creditors to better price risk, and reduce the frequency and severity of financial crises. It is also important to note the value of flexible exchange rates in mitigating excessive capital inflows. All recent crisis countries experienced large capital inflows while they had fixed exchange rates.

I concur with the staff that, as a way to introduce more discipline on cross border interbank market, the Greenspan proposals warrant further examination. I urge the staff to consult with the Basle Committee to ensure that these proposals are considered in the context of the reassessment of the Basle Accord.

Ex-ante Measures to Better Involve the Private Sector

The staff paper reviews the proposals that have been discussed in various fora. The challenge is to select those that are feasible and could gain the support of the official international community and the private sector. The list proposed in paragraph 50 of the main paper is worth pursuing, and we should focus our attention on how to implement those measures. I fully agree with the staff that industrial countries should take the lead and modify their own sovereign bonds to include collective action clauses. This would set the norm in bond markets and allow emerging economies to do the same with minimum increase in borrowing costs. To increase the acceptability of these clauses and forge a consensus among industrial countries as well as emerging economies, it would be useful to organize an international seminar for debt managers.

Private credit lines eliminate, to some degree, the need for debt renegotiation and refinancing in the middle of a financial crisis. The pre-commitment to provide financing at the time of a crisis, would lead to direct involvement by the private sector. Private creditors would be more interested in monitoring developments in the economies of their clients and would have a stake in seeing an orderly resolution of financial crises. This would also reduce the need for official financing. It is true that there is little experience with this type of financing arrangements and that they may suffer from a lack of interested counter-parties. That is, debtors are unlikely to be prepared to pay the extra insurance cost and seek private credit lines when conditions are favorable, and creditors are unlikely to provide credit lines when the conditions are bad. However, there is little risk associated with establishing private credit lines and they are easier to put in place than many of the other measures that have been considered because they do not need to be sanctioned by the international community. Emerging economies should be encouraged to seek such credit lines to protect themselves to the extent possible against a sudden reversal of capital flows.

I share the staff's reservations about official enhancement of new debt (policy-based guarantees). The case for guarantees rests on their ability to help address a market failure. But no strong evidence exists that there has been a market failure. High spreads in emerging economies today do not represent a market failure as a variety of distortions (fixed exchange rates, implicit/explicit guarantees and the presumption of official assistance in the event of a crisis) likely lowered the perceived risks leading to smaller emerging market spreads in the lead up to the Asian crisis. I am also concerned about additionality, the impact on existing obligations and the impact on future non-enhanced borrowing. If official guarantees are to be used, it would be preferable to use them as "sweeteners" to facilitate debt restructuring rather than in the provision of new money.

Some observers are concerned that any ex-ante measure that restricts creditors would lead to less credit and higher spreads for emerging economies. To the extent that a higher spread better reflects risks it would lead to a more efficient allocation of capital, and should be welcomed. Moreover, the proposed measures provide an insurance for which the insured should pay a premium in the form of higher spreads. Such increases in spreads would be much smaller than the emerging market spreads that have been experienced over the past year.

Debt Stand-Stills

While it is important to put in place ex-ante measures to reduce the likelihood of financial crises and help an orderly resolution of them, crises occur and the ex-ante measures may not be adequate. In those circumstances, stand-stills are unavoidable unless the official sector decides to bail out the private sector which is neither desirable nor feasible given the size of capital flows and the resource constraints of the official sector. In fact, the threat of a stand-still could impose adequate discipline on international creditors and reduce speculative investments.

As in a domestic context where debtors can resort to bankruptcy laws to protect themselves, a strong argument can be made that debtors in international markets should also have the option to temporarily suspend payments if there are no other market-based solutions. The purpose of a stand-still would be to prevent a panic run for the exits and a disruptive resolution to a financial crisis. The breathing space that a stand-still provides would also give the sovereign debtor a chance to undertake necessary policy measures to restore confidence in its economy's ability to honor its obligations. The difficulty in an international context is that there is not an international bankruptcy court that can adjudicate international debt disputes. One alternative is to give the Fund, which is uniquely positioned to determine the need for a debt stand-still, the authority to sanction requests for stand-stills. This option has the advantage that the Fund's involvement would ensure that a stand-still would be followed by necessary policy adjustments and structural changes to increase the country's capacity to service its debt.

The staff pays little attention to debt stand-stills and labels them as "extreme measures." The case of Russia is cited to point to the risks associated with this approach. I would argue that the panic in financial markets following the Russian moratorium was mainly the result of the unilateral approach taken by the Russian authorities. Greater transparency should reduce the likelihood and the extent of irrational contagion. Moreover, the deleveraging that occurred after the Russian moratorium and the ensuing market turbulence may not be representative of what would occur in future stand-stills. The post-Russian market developments may have simply reflected the overturning of the widely-held assumption that certain countries were "too big to fail."

The framework within which a debt stand-still can be declared is of less importance than the international community's acceptance of this concept. We should stop treating debt stand-stills as an extreme measure, and accept their effectiveness. A feasible framework can then be designed in close consultation with the private sector. While the initial reaction from private creditors will certainly be negative, they will likely cooperate with the official sector once they realize that the international community is moving in this direction and it would be to their benefit to get involved in the design of the system.

Mr. Eyzaguirre and Mr. Zoccali submitted the following statement:

At the outset, this Chair agrees with the central lessons distilled from the debate to better involve the private sector in forestalling and resolving crisis, as reflected in paragraph 4 of EBS/99/21, Revision 1. In that regard, it is clear that there is no single, or simple solution. Moreover, prevention is key in terms of the need to improve the environment for private sector risk assessment and decision-making as well to develop and implement ex-ante mechanisms for orderly crisis avoidance and resolution. We are convinced that a contingent credit line (CCL), in addition to helping to ring-fence the process of contagion, also has the potential for expediting the participation of the private sector in contingent financing schemes for times of stress. The limitations associated with the latter are directly related to the expected probability attached by the private sector to the activation of their commitments. Such an occurrence should be seen as less likely under an adequately designed CCL, one that also fosters broad implementation of minimum standards in crucial areas. At the same time, an appropriate level of involvement of the private sector in the provision of contingent financing would, in our view, be critical to limit the potential moral hazard of a CCL, and even indispensable given the size of private capital flows vis-a-vis the resources available to the Fund.

When discussing the country eligibility criteria for the CCL, the existence of an adequate profile of its external debt and the progress of the sovereign in securing contingent private resources were highlighted. While we agree with their importance, two additional comments are warranted that, in turn, serve to clarify our approach to the issue of private sector involvement.

First, the degree of involvement of the private sector in the provision of financing is more adequately reflected in the maturity structure of the public debt. Commitments of medium and long-term private sector financing should be seen as the more desirable form of private sector involvement. The eventual inclusion of call options would offer just another means to bring about an appropriate debt structure, in the same manner as the existence of put options on public debt issues would weaken the degree of private sector involvement. Secondly, when assessing the appropriateness of the debt structure, both the external and the internal public debt profiles should be taken into account. If the level of short term internal debt is relatively high, for example, in relation to international reserves, the threat to overall balance of payments stability may be significant.

The main staff paper rightly reminds us that in the recent crisis creditors with long-term claims had no way to unwind their involvement and, therefore, suffered losses. The market has a solution for this type of claims and the prospect of losses provides the right incentives for creditors to undertake more appropriate risk assessments of debtors. The main problem to be tackled is, without doubt, the destabilizing characteristics of short-term capital flows. An adequate public debt structure, including call options, can provide an important safety valve in this regard. Nevertheless, we are still left with the potential difficulty associated with private external short-term debt, particularly since, as the staff paper underscores, private and social costs in this area may differ. While at this stage one could hardly speak of definitive solutions, some ideas could be advanced. First, improved monitoring over capital flows is critical. A greater monitoring frequency over private external liabilities, including an accurate accounting of put options, deserves close consideration. Second, an effective channel of communication between emerging and private capital markets is important to forestall unwarranted levels of inflows or outflows. Needless to say, transparency and predictability regarding the policy-making framework is crucial. Third, we welcome the further consideration being given to measures, along the lines of the Greenspan proposal, to close the wedge between private and social. short-term capital costs, including resort to excess capital and liquidity requirements attuned to country-specific vulnerabilities, such as those in place in Argentina. Similarly, how to avoid the problem of short-term corporate external indebtedness --which has been critical for the stability of the banking system-- deserves further consideration. Some form of taxation of these flows, along the lines used by Chile by way of unremunerated reserve requirements, also deserves further consideration. Fourth, transparency over financial intermediaries such as hedge funds and investment banks is also essential for the success in the efforts to limit the size and volatility of short-term capital flows.

More specifically on measures that facilitate private sector involvement to forestall and resolve financial crisis, we would prioritize progress on contingent financing arrangements, and in embedding call options in interbank loan agreements, although it remains to be seen to what extent such arrangements will be effective in securing additional financing, given the potential for dynamic hedging strategies. At any rate, it is important that the clauses governing these eventual contracts, such as the evergreen clause, be carefully designed to avoid creating incentives for obligatory activation of such lines in times of adverse shocks, and dispel concerns about moral hazard on the debtor side when the country concerned can affect the conditions under which the option may be exercised. This latter point is particularly important in the case of structured notes.

In addition, this Chair would welcome further progress on official enhancements of both contingent and new debt arrangements in the current circumstances, keeping in mind the critical importance of ensuring additionality. In any event, we would agree that this should, in no way, be a means to dilute the conditionality associated with direct official lending.

Korea´s successful experience with concerted roll-overs underscores the crucial contribution of an appropriate structure of public debt as well as of a sound fiscal position to give clear signals of inter-temporal fiscal solvency. We have some doubts, however, about the general applicability of concerted exercises and would be in favor of voluntary reschedulings to the extent possible. The key test of the cost-effectiveness of this approach, and of the bankruptcy procedures in place should generally be its effect on the spreads on emerging markets bonds. If private sector participants come to view these developments as facilitating debt restructuring and the prospects for claims recovery, they should lead to a lowering of spreads. On the contrary, if they are seen predominantly as a threat to creditor interests resulting in an increase in spreads, further dialogue with the private sector participants and caution in this area would be warranted.

With respect to the restructuring of international sovereign bonds, we should stress the critical importance of concerted action by G-10 countries. Thus far, G-10 countries have shown a willingness to consider new contractual terms in their sovereign bond issues, but consideration has remained limited to issues in foreign currency. Since most sovereign bond issues by G-10 countries are made in local currency, further progress is clearly needed.

Finally, given the inevitability of extreme situations, when ex-ante measures do not deliver needed support, we support the further consideration of last resort measures. Concerns about a possible adverse market reaction to their sole discussion may have been dispelled after the G-22 included specific references to this topic and no negative consequences emerged. Nonetheless, given the difficulties associated with the general assessment of the benefits and costs of a default, these last resort options are clearly to be considered on a case-by-case basis, keeping in mind their potential disruptive effects on other countries. In any event, we remain open to the possibility of amending Article VIII, Section 2(b), to allow the Fund to sanction a temporary stay on creditor litigations and see the amendment as facilitating an orderly resolution process. A high qualified majority, however, would, be necessary for decisions on this delicate matter.

Mr. Mori submitted the following statement:

We wish to thank the staff for the comprehensive and well-balanced set of papers on the complex issue of involving the private sector in forestalling and resolving financial crises.

An important conclusion we can draw from the papers is that there are no simple or easily available solutions that can ensure the involvement of the private sector in the resolution of financial crises. The situation faced by a particular country may differ reflecting the unique circumstances in terms, for instance, of its macroeconomic conditions and composition of external liabilities, and a solution adopted for one country could not be necessarily replicated in other cases. The approach needs also to make the distinction whether a country is already in the middle of a crisis or not. Except for extremely severe market conditions, the voluntary nature should be preserved in a scheme to involve the private sector. Therefore, we regard as more appropriate a case-by-case approach with schemes framed to each country's specific circumstances.

One concern in designing a framework to involve the private sector is that proposals to avoid or resolve a crisis could potentially cause more difficulties than solutions. It is important that any move in this direction should avoid excessive damage to prospects for the resumption of market access following a crisis. In addition, certain measures may seem effective for one country but they may also create adverse externalities by intensifying the risks of economic dislocation or increasing the likelihood of a crisis.

Schemes such as concerted rollover and restructuring operations should be strictly limited to extremely severe market conditions in view of their potential systemic consequences. A country may be favored by an immediate cash-flow relief associated with a restructuring of external obligations, but it may face the cost of a significant reduction over the medium-term in its ability to mobilize resources from private creditors, with the concomitant implications for its economic growth. For a country with strong economic prospects, the impact of a restructuring on future market access may be substantial as it would take considerable time to rebuild its track record of creditworthiness and, therefore, restore fully market access. A concerted rollover needs to be an integral part of an ambitious adjustment program.

We agree that the best insurance against the adverse effects arising from shocks to the availability and terms of external debt lies with prevention. In this regard, there is a need to avoid excessive accumulation of short-term external indebtedness, and to ensure adequate levels of both official reserves and banking system liquidity to allow a temporary reduction in capital market access to be handled in an orderly fashion. It is essential for an emerging market country to follow a precautionary policy of monitoring closely capital flows, maintaining an appropriate debt structure, and updating analytical frameworks for vulnerability assessments to reflect the latest market practices. There is also a need for allowing privileged status to longer maturity obligations, as well as implementing measures to impose greater discipline on the cross-border market by addressing capital market bias towards short-term financing.

The staff suggests that countries could seek insurance in the financial market for adverse contingencies in the balance of payments scenarios. The insurance would be designed to counter the tendency for external financing to float with respect to economic developments. Some countries, for instance, in the current financial turmoil are facing the consequences of export revenue being significantly reduced because of depressed external demand and commodity prices, while their external financing resources are contracting. Under such circumstances, an alternative would be to design debt instruments that generate a debt-service burden that varies counter-cyclically against overall economic developments.

Contingent financial arrangements would certainly be an appropriate innovation to provide an efficient private, market-based insurance against adverse market developments , including liquidity risk, beyond the control of policy makers in the affected country. These instruments may also aim to contemplate effective burden sharing during periods of stress in that they involve the private sector in the provision of additional financing to help offset adverse developments in the external accounts.

However, there is a question about the extent to which contingent claims would provide effectively additional balance of payments financing. The existing structure of financial instruments tends to reflect the expected outcomes for a given set of information available to the market at each point in time. If it is so, any new instrument would be redundant and would not add to improve the strategy of risk sharing. In addition, for a given structure of financial instruments, a global investor may adopt dynamic hedging strategies, whereby they offset elsewhere the activation of a contingent arrangement in one country, so as to leave overall exposure to the country (or group of countries) unchanged.

If there is a case of market imperfections because markets are not able to provide a set of contingent claims that generate additional financing in the event of a crisis, the official sector could play a role in completing markets by promoting the use of such instruments. An official risk-sharing scheme may envisage to help solve the market failure and, perhaps, allow for additional private sector exposure, at a reasonable cost, for countries pursuing appropriate macroeconomic and structural policies. At times when normal market access is restricted, official enhancements could be used not only to help reestablish market access but also to mobilize additional finance to emerging markets. The difficulty resides in the design of such a financial instrument to avoid inappropriate incentives and provide an effective leverage by encouraging the private sector to bear additional exposure to a country during difficult periods.

Finally, on international sovereign bonds, we see with interest the proposal to modify contracts to include sharing clauses, modification of terms by qualified majorities, and a collective representation provision. We share the staff's view that a demonstration effect would be instrumental through the inclusion of the new contractual terms in concerted bond issues by G-10 sovereigns.

Mr. Shaalan and Ms. Abdelati submitted the following statement:

We welcome this second consideration of this topic that has emerged and gained prominence following the turmoil in financial markets. The staff paper takes the discussion further and outlines in a clear and balanced manner a number of specific ex-ante and ex-poste measures related to the role of the private sector in financial crisis management. These deserve careful consideration.

Our last discussion emphasized the critical role of prevention through the pursuit of appropriate economic policies, including through strengthening the financial sector, as well as through an improved flow of information to the markets. We therefore need not elaborate further on this issue here, but will comment briefly on a few specific issues staff raised this time around related to the role of the private sector in crises avoidance and orderly resolution.

The recent financial crises have clearly been triggered by the sudden and massive outflows of short-term capital. Massive outflows in one country contributed to similar behavior of the private sector in other countries. For a period in the latter half of 1998, international capital markets were virtually closed to emerging markets further aggravating the financial crises. In these circumstances, we are of the view that a system be expeditiously put in place to monitor and control, through market related means the flow of short-term capital. The monitoring of various forms of short-term external liabilities and the assessment of members' vulnerability is an enormous challenge at the core of preventing future crises. Concerted efforts are needed in improving the assessment of members' vulnerability to shocks, both by the Fund as well as by emerging market members. On the part of members, this calls for frequent monitoring of private external liabilities, particularly of the short-term variety and updating analytical frameworks used to assess vulnerability by taking into account newly introduced market practices. In today's environment, members need to adopt policies to avoid excessive accumulation of short-term liabilities and to ensure adequate banking system liquidity to allow orderly response to a sudden temporary reduction of market access. The Greenspan proposal is a promising initiative for reducing the attractiveness of short-term interbank lending and its early consideration by the Basle Committee would be welcome. The recent exercise of put options, however, and the possibility that these can be exercised en masse, would call for limiting their use in sovereign debt instruments and closely monitoring banks' exposure to such instruments.

We see merit in continuing to examine carefully the usefulness and drawbacks entailed in the ex ante market-based measures intended to ensure private sector involvement in crisis resolution. Each of the measures proposed by the staff holds a mixture of promise and risk. Since our experience is thus far limited and some of these areas could prove more risky than can now be foreseen, we would endorse the view that progress in this area needs to be evolutionary rather than revolutionary. The recent experience with contingent credit lines possibly holds an encouraging prospect as these provide an avenue for burden sharing in the provision of new financing. Given the very limited experience thus far, there is reasonable concern that their activation could adversely affect other members though banks partially offsetting transactions, but such arrangements nevertheless, appear to hold some promise. Regarding the call options in interbank credit lines allowing for extension of maturities, there is the problem of identifying an appropriate trigger and the risk that creditors may pull out earlier than otherwise thereby possibly causing the onset of a crisis that might not have happened in the absence of such an option. We therefore share staff's skepticism regarding the benefits that this approach could yield. There does seem to be some merit in designing debt instruments with counter-cyclically adjusted debt service payments, particularly for primary commodity exporters. In this case, the linking of debt service payments to movements in an internationally traded commodity would credibly be considered a development beyond the control of the authorities. The modification of international sovereign bonds is another promising area that deserves further examination and will hopefully be agreed among to the G-7 in the near future.

With respect to official guarantees or enhancements of new debt through a World Bank guarantee, we are skeptical of the usefulness of this mechanism in the case of restoring access after a crisis. As noted by staff, such enhancements may limit access to non-guaranteed borrowing or crowd out official lending. We would however, see some merit in the use of such enhancements in overcoming a potential market failure entailed in introducing to capital markets a country without market access i.e. in the absence of a crisis, thereby extending project-based guarantees to balance of payments support.

On rollovers, recent cases of moral suasion after the onset of a serious crisis have been used with varying degrees of success. We would agree with the position espoused by the staff that this technique of bailing in private creditors should only be used in the most extreme circumstances where a default is imminent and where the rollover is not viewed as a substitute for appropriate macroeconomic policies. The recent experience with the ongoing Brazil rollover endeavors need to be carefully assessed. The staff rightly put forth the proposition that when voluntary debt restructuring could not be reached, and pressures in the external accounts reach severe levels with systemic repercussions for reserves and the exchange rate, consideration of a default on sovereign debt and the imposition of exchange controls cannot be avoided. This course of action has its well known drawbacks. As such, we believe there may be a case for declaring a moratorium until a debt work-out can be agreed upon so as to prevent dissident creditors from blocking progress toward an orderly work-out. The existence of such a mechanism could well discourage disorderly behavior, possibly without the need to activate it. If such a mechanism were established, we see merit in staff's proposal of adopting a cutoff date and requiring a majority decision. We therefore look forward to the discussion of possible amendment of Article VIII, Section 2(b) in a forthcoming seminar.

Further work is needed to identify the counterproductive effects of pursuing any of these measures for involving the private sector and we must continue efforts to elaborate and implement promising proposals, in collaboration with other concerned institutions. Here, we would emphasize that we need to involve the private sector in our deliberations on this subject. Staff views on the nature and format for such involvement would be appreciated.

Mr. Guzmán-Calafell sumbitted the following statement:

The involvement of the private sector in crisis prevention and resolution has been pointed out in a number of Board discussions as one of the most important elements of the efforts under way to strengthen the architecture of the international monetary system. Nevertheless, this is an extremely complex subject, and therefore it is not surprising to see that despite the fact that this issue has been the focus of significant attention at the Fund and other fora, progress to date in moving forward with concrete proposals is modest.

Furthermore, the papers prepared for today's discussion do not leave much ground for optimism in this regard. The staff notes that the debate of the involvement of the private sector in forestalling and resolving crises in a range of fora makes it evident that most of the possible courses of action have undesirable side effects, that there are no simple or easy solutions available, and that movement in this area will be evolutionary rather than revolutionary.

The nature of the papers prepared by the staff is also a reflection of the complexities that surround this subject. They present a useful analysis of the key proposals for involving the private sector in forestalling and resolving crises, with some additional information incorporated to the work presented in previous papers. However, I have the impression that to some extent we are moving in circles, and that the value added to the studies prepared for earlier discussions is relatively modest.

The staff notes that in a few cases decisions and actions on private sector involvement fall mainly within the responsibility of the Fund, and that for others authority lies elsewhere. In my view, what we should do at this stage is to identify those areas in which the Fund can make a contribution, and then come up with specific suggestions for action in these cases. The paper identifies a number of ex-ante proposals where urgent action is recommended. Let me comment briefly on them.

The need for an active involvement of the Fund in the development and, in some cases, implementation of appropriate debt-monitoring systems is evident. As explained in the background paper, the Fund has accumulated valuable experience in this area, as debt- monitoring systems have been introduced in the context of Fund arrangements in Korea, Thailand, Indonesia, and Brazil, and similar efforts are under way in a number of other countries to improve surveillance over short-term capital movements and to provide early warnings of emerging problems. In view of the importance of the availability of adequate statistical information on external debt for crisis prevention, there is no doubt that efforts of this nature should be widened to the extent possible.

The staff also points to the need for progress in the agenda on standards and transparency. I agree that there is an important role for the Fund in these efforts and that this can help to improve the environment for efficient private sector decision making. Nevertheless, it must also be noted that this issue is only indirectly related to that of private sector involvement in financial crises, and that at least in the area of standards progress is likely to be slow.

Another activity where there seems to be scope for an active participation by the Fund relates to the search for means for an effective communication between debtors and creditors. Although the Board's initial reaction to this proposal was mixed, I have the impression that the objections raised by some Directors during the earlier consideration of this issue do not give rise to unsurmountable difficulties, and thus initiatives like the creation of creditor-debtor councils deserve further analysis. If this is an opinion shared by the majority of the Board, the staff should prepare specific proposals for Board discussion, with a view to presenting them for the consideration of the Interim Committee during the April meeting.

The possibility of amending Article VIII, section 2(b) to introduce a mechanism for allowing the official community a temporary stay on creditor litigation has to be kept under study. This is an area which does not have yet the required support at the Board and where a breakthrough in the short term is unlikely. However, since progress on finding adequate mechanisms for the involvement of the private sector in crisis prevention and resolution is uncertain, it is preferable to leave this option on the table and continue the search for spaces that can attract a wider support, since the possibility of needing a mechanism like this in the future cannot be excluded.

Regarding the negotiation of contingent financing mechanisms with commercial banks, the role envisaged for the Fund is to encourage emerging-market countries to talk to their banks about the possibility of putting in place arrangements of this nature. While this proposal is reasonable, we must keep our feet on the ground and avoid raising excessive expectations. As noted in the paper, it seems unlikely that banks would be willing to negotiate arrangements of this nature with a large number of countries, and these instruments have other disadvantages. The recent experience of Mexico is illustrative of the restrictions that contingent financing mechanisms with commercial banks may face. Mexico's credit line was designed to face extraordinary external shocks that could adversely affect the economy. These contingencies occurred, since the decline in the price of oil had a sharp impact on the balance of payments and due to external events Mexico's access to international capital markets was severely restricted. Despite the fact that the conditions for the activation of the credit line were present, as explained in the paper, creditor banks argued against the drawing and noted that this could lead to lower lending to corporate borrowers or other Latin American borrowers.

The staff raises the issue of the role of the official sector in supporting contingent credit lines with commercial banks if they are considered desirable, and the recent experience of a contingent loan from the World Bank to Argentina is mentioned. I believe that it would be useful to hear some further staff thoughts on the pros and cons of involving the official sector in operations of this nature, as well as on the potential role that the Fund could play in this regard. On the other hand, I am of the opinion that there is room for further efforts regarding official enhancements of new emerging-market debt. Although I agree that countries with heavily concentrated exports should explore the possibility of linking debt-service obligations to commodity prices, I do not see a major role for the Fund in these endeavors.

The degree to which the Fund should be involved in the remaining areas for action identified on page 25 of the report is not clear. Responsibility for implementing the Greenspan proposal rests essentially on the Basle Committee. The modification of the terms of bond contracts to introduce sharing clauses and majority decision rules depends mostly on actions to be taken by the main industrial countries. In particular, the incorporation to industrial countries' sovereign issues of clauses like these appears to be an essential prerequisite for its successful use among emerging country borrowers. In any event, we need to define if there is a role for the Fund in these efforts and, if this is the case, specify the courses of action to be taken.

Finally, I would just like to reiterate that after a number of discussions of the involvement of the private sector in forestalling and resolving crises at the Fund and in other fora, the time has come to move forward with concrete proposals. An active Fund involvement to this end is warranted in some areas, and it is here that we should concentrate our efforts. But it is clear that headway is going to be slow. I believe that it is essential to be realistic and have this in mind, particularly when we think about conditioning possible actions in other domains to progress on the issue of the involvement of the private sector in financial crises.

Mr. Wijnholds submitted the following statement:

Many of the ideas on private sector involvement which were floated over the course of the last year and a half, have started to gather dust. Perhaps this is because we have all been browbeaten by the complexity of the issues confronting us and the problems with implementing many proposals which would seem interesting in theory, though insurmountably difficult to execute in practice. Whatever the reason, there is broad agreement that we now need to make some tough choices and urgently implement those ideas which offer most promise. In doing so, we must not let the perfect become the enemy of the good. Although I will briefly provide my thoughts on the various options for private sector involvement in the paper, my remarks are primarily aimed at identifying those areas where the Fund can move forward. Let me start, however, with a few introductory comments.

The rationale for better private sector involvement

I believe staff rightly highlights, as a basic premise for our discussion, the fundamental principle that contracts should be honored. Our discussions of course focuses on that very small segment of cases where contracts cannot be honored (akin to bankruptcy situations at a non-sovereign level) and where workouts can be disorderly and disruptive. Here I see at least three important caveats in the way markets currently work (i.e. a market failure or a negative externality), which could warrant a role for some form of official intervention. First, in several recent crises, short term debt holders have managed to get out of a crisis country unscathed, sometimes aided by the provision of official money. The fact that this applies in particular to short-term debt holders is perverse in that this type of debt is often the cause of a country's vulnerability and its withdrawal can trigger the crisis. Moreover, the fact that this segment of creditors sometimes escapes the penalty for what would seem to have been a poor investment, raises concerns about the possible precipitation of future crises (caveat 1).

Second, even if many (groups of) creditors take losses, there are no pre-established rules for an orderly sovereign debt workout, along the lines of bankruptcy regimes at a national level. This can lead to disorderly workouts which are not only excessively painful to the debtor country, but also entail negative externalities for the rest of the international community (caveat 2).

Third, there is a problem of domestic capital flight, which I believe has been somewhat under-emphasized in our discussions up to now. Even though domestic capital flight does not constitute a creditor group vis-à-vis which a country could default or whose debts could be restructured, it can be a source of undue pressure on the exchange rate and international reserves. Thus there would seem to be a need to 'capture'/bail in domestic residents in times of crisis also, or at least monitor their behavior (caveat 3).

In attempting to address these caveats, I am concerned with two issues raised in the staff paper. It is stated that 'contagion is always a concern' and that, in our crisis resolution, we should avoid broader adverse effects on other countries. While in itself this is true, I fear that 'contagion' will become an excuse for inactivity. In the current environment, there is probably not a single emerging market which would not have (some degree of) a systemic effect. While a few years ago the concept of 'too big too fail' seemed to apply to only a handful of countries, the interconnectedness of capital flows has altered the entire concept of 'size' in the international monetary system. My second concern relates to staff's remark that some of the proposals to reduce vulnerability in crisis times could lead to a higher cost of lending in normal times. I would think that this is a good thing, not a bad thing. If anything, there has been an oversupply of lending to some of the countries struck by financial crisis, or, at a minimum, the lending has been insufficiently targeted at profitable debtors (corporates and banks) and investments. In this regard, I would note that I was heartened by Mr. Fischer's briefing last Friday in which he indicated that commercial banks had complained about the Fund's heavy handed approach in the case of Ukraine. In my view, this means we must be doing at least something right!

Comments on measures to facilitate private sector involvement

Private contingent lines of credit; call options; debt service insurance; official enhancements

As I stated during our last meeting on this topic, I support contingent credit lines as a form of market-based insurance against adverse developments and liquidity risk. To use such credit lines as a first line of defense would seem preferable to using money from international financial institutions. Of course staff is right that there are many potential down sides: moral hazard, the question whether there is additionality, possible crowding out of other lending, dynamic hedging and possible contagion effects on other countries. Indeed, Mexico's experience in activating these lines certainly gives pause for thought. However, staff rightly notes that we do not have sufficient experience to form a judgement one way or the other. Put differently, it is not yet clear that there is some kind of market failure, and until this is the case it would be premature for the official community to oppose what is essentially an instrument developed by private markets. In fact, I think it's laudable that Argentina, Mexico and Indonesia have been willing to buy such insurance.

Partly because it is still unclear if private contingent credit lines will, on balance, turn out to be a good or a bad thing, I would be opposed to any kind of official enhancement of such contingent lines. In addition, I share many of staff's doubts about official enhancements laid out extensively in the background paper. The case of a market failure is unclear (markets are extremely adapt at stripping risks, raising the question why they would adopt risk in the framework of a partial guarantee that they would not otherwise adopt), as is the question of additionality. Moreover, such official enhancements may actually increase the rigidity of the debt stock, entangle private and official debt, and complicate a debt workout in times of crisis. Finally, guarantees cannot be reversed once they have been extended and therefore are much akin to single tranche adjustment loans. This actually raises concerns about moral hazard on the debtor side, as conditionality may be by-passed.

My thinking about call options and structured notes is the same. As long as these are market instruments which appear to reduce a country's vulnerability to financial crises, we should encourage countries to buy them. I find the paper much too dismissive in this regard, particularly as it is unclear if any of the downside risks that are identified will ever materialize (if markets for these instruments will never develop because of pricing problems, so be it). Of course, countries may be reluctant to pay the higher price associated with such insurance, but there is no harm in encouraging them to explore the purchase of such private insurance. As with private contingent credit lines, our encouragement should not go as far as to actually force countries to buy such instruments, or to officially enhance them by offering guarantee. Again, because their effects are still unclear.

External debt monitoring and concerted rollovers

Given the growing importance of capital flows and their potential to exacerbate vulnerabilities in emerging markets, the monitoring of short-term debt is bound to play an increasingly important role. In this regard, I believe staff is overstating some of the potential problems associated with such monitoring arrangements. For instance, it is stated that a concerted roll-over could be seen as providing a substitute for appropriate macroeconomic policies. But are appropriate economic policies not ensured by Fund conditionality? It is unclear to me what staff is basing this fear on; in none of the crisis countries with monitoring arrangements has there been ensuing moral hazard on the debtor side. I also do not agree that such monitoring arrangements should be limited to cases where a default is imminent. This is precisely the self-fulfilling scenario - i.e. that monitoring will be associated with trouble - that staff is trying to avoid. The emphasis with such monitoring arrangements should generally be on 'information exchange', not on 'moral suasion'. To the extent that the two are now perceived as being equal, more frequent use of monitoring arrangements should serve to diminish the sound of alarm bells going off. Staff seems to equate monitoring exercises with the 'Korea-model', whereas there is of course also an 'Indonesia-model', a 'Thailand-model' and a 'Brazil-model', all of which were very different. Personally, I did find our monitoring experience in Korea much more effective than in Indonesia, primarily because this also involved a reconciliation exercise with data from the creditor side. As I stated during the last discussion: the absence of such a reconciliation exercise in Indonesia led us to revise downwards our initial estimate of the stock of interbank debt by more than 50 percent (some $ 6 bln). I was surprised that neither the paper nor the background paper mentioned this.

At the same time, I agree that it would not make sense to establish such monitoring arrangements in every country, particularly as an effective monitoring arrangement is likely to require involvement from creditor supervisory authorities and the creditors themselves. Therefore, such monitoring arrangements should, in my view, be limited to those cases where there is significant short term debt relative to reserves or balance of payments flows. In times of crisis, however, we should again attempt to be more ambitious and try to broaden the coverage beyond interbank debt. The rationale would be that we are not just trying to bail in the banks but all of the private sector. Moreover, information on domestic capital flight can play an important role in our consideration of the viability of a program or an exchange rate regime.

Bond clauses, bankruptcy procedures and temporary stays on creditor litigation

Here I am in agreement with staff's analysis. Let me just reiterate that I would support amending article VIII 2.b. It seems to me you can't manage a global crisis without having, at least as an ultimate remedium, global tools. Having said that, I would expect the Article to be rarely invoked, if ever. Much akin to bankruptcy procedures, however, it could provide incentives to creditors to cooperate in a voluntary restructuring rather than embarking on disruptive litigation. In addition, staff suggests two interesting safeguards - to require a high voting majority for use of the article and to adopt a cut-off date for the stay - both of which I could support.

Next steps: what's the role of the Fund?

So how do we move forward? I suggest staff comes back to the Board with several concrete recommendations/decisions which we could accept.

We could adopt a statement of principle to guide the management and resolution of exceptional and extreme crisis (perhaps along the lines of paragraph 4.8 of the G-22 report). Although by no means a framework, such a broad outline of how we expect countries to behave in such extreme circumstances - for instance stipulating that countries should not declare unilateral moratoria and should strive to involve the private sector in a voluntary manner - could provide some clarity to markets about the 'rules of the game'. These rules have clearly changed over the last year and a half. I believe it is better to be explicit about them and reassert some semblance of control over the system, rather than letting markets fall from one unpleasant surprise into the next. Perhaps such a statement could form the basis of a statement by the Interim Committee.

There appears to be a consensus on the benefit of including sharing clauses, majority clauses and collective action clauses in bond contracts. There could thus be merit in making such clauses a standard recommendation in Fund surveillance and Fund programs, for the issuance of external bond debt (industrial countries could be asked to issue a token external bond; until now they have not led by example, in part because few issue any sovereign external debt). For instance, for a program country this would entail stipulating that during the course of the program a country would only be allowed to issue debt with those clauses.

The Board could formally endorse the more frequent use of monitoring arrangements for countries with a significant short term debt (relative to reserves or balance of payments flows). This may merely codify existing practice, but it seems useful to acknowledge some of our 'learning by doing'.

The Fund develop benchmarks/guidelines on what constitutes a 'healthy' debt structure and to provide recommendations to this effect in Fund surveillance and Fund conditionality. In other words, the Fund could be more specific about 'adequate' levels of reserves, 'excessive' levels of short-term debt and 'excessively' rigid debt structures. The concept of the adequacy of reserves in months of imports is clearly outdated and perhaps we should come up with more novel concepts for emerging markets. As for reserves the most obvious benchmark would seem to be to assess the adequacy as a percentage (100 percent) of short term debt, but for the composition of debt this is much less straightforward. Therefore, we should perhaps develop formal benchmarks (along the line of our vulnerability indicators although we can't call them that) and make these a part of our surveillance. In a similar vein, in our surveillance guidelines, we could discourage the use of put-options and acceleration clauses in sovereign debt contracts.

The Fund could encourage countries to buy private forms of insurance and explore ways to improve their debt structure, in part through the purchase of innovative financial instruments.

I agree with staff as regards their recommendations in paragraph 51.

The Fund could do more work on vulnerability indicators and sensitivity analysis pertaining to the stock of debt and the balance sheets of the banking system (e.g. the effect of exchange rate and interest rate movements on the debt profile). Currently, much of the Fund's work on vulnerability indicators in staff reports is still very much flow-oriented, despite the acknowledgment that stock-problems lie at the heart of the crisis in Asia, in particular.

One final way to stimulate private sector investment is for the Fund to disburse smaller packages. Here I am in complete agreement with Mr. Bernes. I believe there is broad agreement on the dangers of moral hazard, the political infeasibility of ever larger Fund financing packages and the need to involve the private sector. Put differently, I believe there is agreement that the Fund should never fill the entire financing gap of a country through its own lending (although we may disagree on the degree to which it should be filled). It is no secret that, in this regard, I am deeply concerned about the absence of access limits for the SRF and the possible creation of a CCL-facility. However, given our common ground, I wonder whether we should not attempt to formulate some kind of access limits for the SRF, perhaps not defined in terms of quota, but in terms of what percentage of the financing gap, at a maximum, will be filled by the Fund.

Mr. Taylor submitted the following statement:

We believe that the issue of "bailing in" private sector creditors in the resolution of financial crises is an important issue warranting careful analysis, for a number of reasons including:

- If an effective bailing in solution is not found, there is a higher risk that bailing out the creditors (through debtor countries) might become the standard response - the potential risk here could become much larger under the proposed CCL scheme;
- Credit allocation and pricing decisions are more likely to take into account relevant risk considerations than in an environment where creditors operate on an assumption that they may be insulated from the risks of default by "bail out";
- Effective bailing in mechanisms - if they can be found - offer potential benefits relative to uncoordinated debt defaults. These benefits potentially include reduced risk of loss by creditors and a more orderly resolution of the debt servicing situation.

We therefore support further analysis by the IMF of the options. Of course, prevention is obviously the preferred option in all of this. We strongly endorse the message presented in the paper - namely that all efforts should be made to reduce vulnerabilities, improve private sector risk assessment and decision-making, and the flow of information.

Sections II and III of the paper identify a number of mechanisms which would be desirable if practicable (although not flagged in the paper, we could add the avoidance of distorted signals to both borrower and creditor through pegged exchange rates not supported by appropriate policy settings). No doubt these have been discussed extensively with the private sector, but this is not evident in the paper. To what extent are we able to say that the options are regarded as acceptable by the private sector - or is there a need for some kind of further concerted, public consultation in this respect?

We should listen carefully to the views and experiences of our program countries, as well as the views of creditors and financiers. There is a lot that could be learned from the experience of Korea, for example. This is a case where, in the short-run, the economic adjustment program, however stringent, was insufficient to re-establish stability and confidence without direct association between creditors and debtors. This raises the question of how "creditor/debtor councils" should be organized and what role the Fund should play in them.

In our view, the Fund should take the role, at a minimum, of offering its good offices in supporting a creditor/debtor council, and should probably take a somewhat more active role, covering these activities:

(I) offering active advice to the debtor country regarding past experience on which creditors to contact, and on the selection of Advisors - inter alia, with a view to saving as much time as possible in a time-critical process;

(ii) participate in the council, at least in terms of supporting information flows, but also in other respects such as seeking an appropriate relationship between the council and the development of the adjustment program, and

(iii) providing good offices and moral support for rollover operations or whatever else the council judges is necessary in terms of short-term intervention.

It is inevitable that an arrangement like a creditor/debtor council generates insider/outsider information problems in some degree. In our view this is not a sufficient reason for not proceeding: we should consider how best to reduce the risks through careful consideration of the relationship between inside banks and other banks; country coverage; and an ad referendum process of highly qualified majority support from outside creditors before final decisions are reached.

We agree strongly with the paper (para 4) that mechanisms are also needed for extreme situations where a crisis forces a country to consider some combination of a default on sovereign obligations and the imposition of exchange controls. The most important issue is whether, in such extreme situations, the multilateral framework can be maintained.

- The involvement of other parties could take the form of allowing a third party such as the IMF to declare a stand-fast by way of the inclusion by national authorities of a clause in cross-border or cross-currency bond covenants and loan agreements. The IMF's Articles of Agreement could be amended to allow it to declare a stand-fast.

- If these options are regarded as impracticable, or unacceptable to the membership generally, then it is still possible and desirable to consider less formal arrangements involving declaration by the national government of some form of stand-fast after consultation with the IMF and other interested parties, with the IMF and the other parties making a simultaneous statement in support of the stand-fast (and of the associated Fund reform program).

The need to put in place a framework to deal with crisis management in extreme situations is not fully developed in the concluding observations in the paper. The worst situation is for the international system to break down, either through paralysis amongst the major decision-makers or through unilateral action against the debtor. More work is needed on analyzing how to handle extreme cases, including:

- accepting the principle that some form of negotiated temporary intervention involving interruption of payment is preferable to uncoordinated default;

- seeking greater agreement amongst the major creditors and IFIs on when to intervene - for example, while it may, as the paper argues, be desirable to delay orchestrating bank rollovers until default is imminent, earlier intervention (as we have argued above) may be essential if Fund programs are not to fail repeatedly;

- dispassionate consideration of whether a more generalized application of rationing through exchange control may, in particular situations, be less disturbing to the markets and more equitable and efficient than partial and uncoordinated action;

- if, in the end, there is unilateral action by the debtor - e.g., because the debtor can't or won't agree on financial terms or adjustment measures - then means of containing the contagion by separating this case from other vulnerable cases should be developed if possible.

We consider that, in practice, the handling of extreme cases is likely to require some degree of initiative and leadership from the IMF. At the least, it seems difficult to avoid the IMF playing some role, if only as a 'go-between'. We should give thought to why there appear to have been reservations about this.

Finally, the relationship between bail-in and the formulation of Fund-supported packages needs further consideration. Over the past 18 months, the announcement of the package of adjustment measures has, more often than not, been followed by an immediate reduction in confidence and increase in capital outflow. The extent to which this may have been due to imperfectly designed adjustment measures, or lack of ownership and implementation by the debtor, or whether the debt overhang was out of proportion to the credibility of the program to the market, will be considered further at the forthcoming Manila Framework Meeting.

Mr. Pickford submitted the following statement:

I am grateful to the staff for the extensive work they have done in this area and for the two useful papers which they have produced. We now need to make progress on the issues raised in these papers, in parallel with our ongoing work on the Contingent Credit Line. On crisis prevention, I broadly agree with the staff that the list of proposals in para 51 of the main paper look promising and should be pursued as a matter of urgency. On crisis resolution, I am somewhat less worried than the staff that the ex-ante establishment of measures for resolving crises will of itself significantly increase the risk of a crisis. I think some kind of formal framework for standstills is worthy of further consideration.

Before turning to both these issues in turn, I have one general comment on the staff paper. I think that staff have tended to over emphasize potential disadvantages attached to some of the proposals. A more even-handed approach would have been to attempt to weigh up the potential costs in relation to the potential benefits of each proposal.

CRISIS PREVENTION AND FORESTALLING

I will comment very briefly on the key proposals which have been made in this area:

- first, I agree with the need to improve communication between debtors and creditors. My authorities favor the establishment of what some have called 'country club networks' with investors, to facilitate an exchange of views and information about economic policies and prospects. These networks should be established in normal times but could, of course, prove even more useful in times of market stress. They should also make it easier to assess what kind of policies will increase or damage market confidence. It would be the responsibility of countries, not the IMF, to set up these networks. But the international official community should also deepen its dialogue with the private sector, through ongoing discussions about broader and more systemic issues facing the world economy. The new Financial Stability Forum could be one vehicle through which such a dialogue might be developed.

- Second, there are important links to the wider agenda on transparency and standards, which we are discussing elsewhere. But in the context of today's meeting I was particularly struck by the discussion in the background paper of put options and other derivatives contracts, which can have a significant impact on a country's balance of payments position. These instruments are not necessarily bad per se. But there is a transparency issue here to the extent that derivative contracts make it relatively easy to hide or obfuscate bad news. This can only store up problems for later. I therefore welcome the fact that Fund staff have strengthened the focus on these types of instruments in the context of surveillance and use of Fund resources.

- Third, I also welcome efforts under way to strengthen external debt monitoring systems in emerging markets. I think this should become routine, both in normal times and in situations of market stress.

- Fourth, I remain of the view that contingent lines of credit can be helpful in enabling some countries to secure access to additional financing in the event of a crisis. As staff note, there are doubts about how much of this financing may be crowded out by dynamic hedging. But Mexico's recent experience appears to suggest that the net additional financing provided can still be significant.

- Fifth, I continue to support the greater use of collective action clauses in bond contracts. These proposals are largely about crisis resolution. But they could also influence private sector behavior ahead of a crisis. The key here is implementation (as indeed it is in all these proposals). The major industrial countries can take the lead in their own markets, for example, by establishing a standard for bond issues which emerging markets could follow, or by encouraging or requiring issuers about to come to their markets to include collective action clauses in their bond issues. The G7 is committed to try and achieve consensus on how to proceed by the Koln summit. But I think there could also be a role for the IMF in encouraging its members to make greater use of modified bond contracts, for instance by considering whether there is a case for more explicit IMF incentives (such as more favorable lending terms if such clauses are adopted).
- Sixth, my authorities remain keen to explore the possibilities for use of official guarantees in encouraging private sector flows to emerging markets. The World Bank proposal to introduce policy based guarantees is one new idea in this area. I welcome the analysis in the staff paper of the issues surrounding the introduction of policy based guarantees, although it is somewhat disconcerting that staff still seem to have so many concerns on the value of this product. We would not wish to see new products introduced without agreement between the Bank and Fund on their suitability. This issue will be discussed in more detail later today in the Bank, where I hope that the Fund will be represented and willing to provide advice to the Bank Board. I would also hope that a full dialogue

could take place between Bank and Fund staff on this issue over the coming weeks.

Seventh, I think proposals to make more extensive use of instruments which provide some form of debt service insurance are worth further consideration. They would more closely align a country's repayment profile to its ability to pay, and so automatically provide hedging against adverse shocks for the debtor. It may also be worth considering a wider range of equity-like debt instruments, and not just instruments linked to commodity prices as suggested by the staff.

CRISIS RESOLUTION

The issue here is whether a crisis resolution mechanism can or should be set up in advance for bailing in private sector creditors and promoting orderly debt workouts.

The international community's approach so far has been to consider each crisis country, and the possibilities for debt workouts, on a case by case basis. It was hoped that this would lead to the establishment of a body of practical experience which could then serve as a guide to best practice, and obviate the need for any mechanism to be agreed in advance.

But it is not clear to me that this is producing optimal outcomes for the global economy. We have had a deep and protracted global financial crisis which is now almost two years old. Our experience of restructuring international sovereign bonds has not been encouraging. And our ad hoc approach has done nothing to encourage greater use of the contractual provisions contained in what have become known as British-style bonds, which in principle at least, would facilitate the more efficient resolution of crises.

The alternative approach is to introduce ex-ante mechanisms which provide for officially sanctioned debt standstills or moratoria in the event of extreme crisis situations. The aim would be to limit the ability of the private sector to fulfil contractual obligations to make certain payments abroad, while the country agrees and implements an IMF-supported programme. Such an approach may require:

- the possibility of introducing foreign exchange controls to protect reserves;

- a means of imposing a stay on creditor litigation, possibly but not necessarily through an amendment to IMF Articles.

It is clear that there would be collateral damage for the country in question in the event of a rescheduling, even where officially-sanctioned. But a moratorium on repayments should be an unattractive option for any country. And I think that any contagion to other countries would be limited if rescheduling took place under a clear, orderly, and officially-endorsed framework.

There is, of course, a legitimate concern that ex ante measures to resolve crises could run the risk of precipitating crises. But it is important to weigh this risk against the potential benefits. If we have a non-voluntary mechanism for officially-endorsed standstills in place, it could help to promote voluntarily agreed orderly workouts.

My authorities are prepared to consider such mechanisms. Inevitably we would need further work in a number of areas to flesh out the details of such a mechanism. I will not venture into these areas now, which will, in any event, be addressed in the forthcoming meetings and seminars on bankruptcy regimes, operational issues surrounding lending into arrears, the role of capital controls, and the legal issues surrounding international debt issues. But these mechanisms could play a role, as another part of our response to the global financial crisis.

Mrs. Hetrakul made the following statement:

We welcome the comprehensive discussion and background papers on this timely topic and would like to commend staff for the effort put in to prepare these excellent papers. Table 1 on the progress of various works is found to be very useful in keeping track of what we and other relevant bodies have accomplished so far and what remains to be done. We are pleased to note a shift in focus from crisis resolution to ex ante measures, making the papers more balanced and in tune with our objective of averting a contagion. Many of the proposed measures to forestall financial crises deserve serious consideration and further efforts should be made to put them into practical use. These facilities/mechanisms are basically meant for those countries on the verge of crisis and thus they should be quick to activate without any lengthy negotiation involved. Nevertheless, one should be reminded that the first line of defense must always be prevention.

What Is Missing

In this respect, one important issue remains missing from our deliberation. We are referring to paragraph 2 of the Concluding Remarks by the Chairman at the last meeting on the issue which stresses the critical importance of "the availability of timely and transparent data from both private and public parties in creditor and debtor countries based upon commonly accepted standards." There are two different, but relating, elements involved here--informational symmetry and prudential regulation. The latter is the means to ensuring achievement of the former. If markets are not ready or reluctant to disclose their activities or impose self-discipline, it is then the responsibility of the authorities and/or international bodies to introduce international best practices or accepted standards, and monitor their compliance with an aim to maintain an orderly function and stability of the globalized financial system, as well as to reduce systemic risk. There have been increasing calls from both developed and emerging market economies to increase transparency of the markets, particularly the highly leveraged institutional investors. Although this work may have been taken up by other fora, we still consider it within the legitimate domain of the Fund, the institution responsible for maintaining the stability of the international monetary and financial system. While we applaud the Code of Good Practices for Transparency in Monetary and Financial Policies, we believe another code is necessary for the markets as well.

From the various issues discussed in the paper, we have gathered that the focus of the private sector in this exercise is the commercial banks, or to be more precise, the lending side. This is apparent from the discussion of measures elaborated in Chapter III, with the exception of the modification of the bond contracts. From the experience of the member countries in our constituency, there are other parties involved in, and in some cases precipitating, the crises. To name a few, many hedge funds, investment houses, and proprietary trading arms of the commercial banks, were among those who influenced the course of the exchange rates in the markets. Their capacity in making positions before unwinding them in a systematic way is certainly a subject that needs to be studied further if we would like to get a bigger picture of the crisis. The lending arms of the commercial banks usually have a longer-term horizon than other players, so that their willingness to help countries in crisis is more readily available.

However, especially at the initial stage of the crisis, the accumulation of positions (say, long on the local currency) through derivative transactions give these market players a very powerful position in moving the exchange rates. At the time when the exchange rate depreciates, these players will unwind their position to realize their profits. Therefore, measures should be carefully crafted to preclude this destabilizing action.

This being said, we wish to comment on some specific proposals outlined in the papers.

Prevention

On prevention, the idea of raising cost of short-term cross-border capital flows along the line of the Greenspan proposal is worth exploring. Banks should be discouraged from engaging in excessive short-term borrowing or facing higher costs of such borrowing. Through this means, more prudence will be exercised in credit analysis and discriminating among customers. The authorities should also monitor closely these funds through a well-designed reporting system, and be able to detect any abnormality or unhealthy signs, for example, mismatching of maturities and currencies, and unproductive use of funds. Action on the lending side as proposed, however, may be too uniform across the board, and thus stops the availability of still needed short-term funding to emerging countries altogether. It is not in the interest of the borrowing country to see this happen, but rather to stabilize the flows and ensure the most efficient use.

Ex Ante Measures

We specifically favor voluntary and market-based instruments, in particular, contingent financing arrangements from commercial banks, official enhancements of new debt, and concerted rollovers of interbank lines. The crisis-stricken countries in Asia have significantly benefited from these three facilities available to them. Indonesia managed to draw part of the US$ 2 billion stand-by credit from foreign banks. Korea successfully encouraged banks to rollover short-term credit lines and had their loans restructured on a concerted basis, albeit with government guarantee. Though successful in Korea, its application remains very limited to certain exceptional cases. So long as we can address the issue of moral hazard and ensure that public fund will not be used to bail out private creditors, the technique is worth attempting to provide a breathing time during the adjustment process.

Thailand was able to secure $ 950 million from international capital markets, with the Asian Development Bank acting as a credit enhancer. Recently, the World Bank's partial guarantee on the US$ 300 million bonds issued by the Electricity Generating of Thailand (EGAT) has also proven useful in helping the Thai state enterprise access the international capital market that was otherwise unavailable at a reasonable spread.

As for Indonesia, at the initial stage of the crisis, Indonesia received a lot of offers from many investment houses and banks that were willing to cooperate with the authorities in preventing a sharper deterioration of the currency. The instrument offered to the authorities was in the form of option, called by the name of "Dual Currency Notes or Bonds". The mechanics of such instrument is as follows:

- The authorities will issue dual currency notes with maturity of, say, 18 months. These notes feature an option for the investors to be paid back either in local currency (Rupiah) at the rate of benchmark local interest rates (in Indonesia SBI rates) minus 3 percent, or to be paid back in the form of US dollar at the rate of LIBOR minus 0.5 percent.

- This feature provides a greater incentive for the holders if the local currency appreciates. This is because, by having an appreciation of the currency, the investors will choose the option of being paid back in local currency with high interest rate (SBI minus 3) plus the incremental appreciation of the currency. The local currency will then be converted into US dollar by the investors through a certain arrangement, yielding a net return to the investors that is high enough to induce them to invest in the notes at short notice.

- With an incentive to have a stronger local currency, the investors will try to help protect the currency from weakening further, and if possible to return to the rate close to the pre-crisis level.

This instrument was claimed to be successfully launched in Mexico during its crisis. Likewise, Indonesia was offered this financing arrangement in an amount of US$ 5 billion within one week's time. The Philippines agreed to utilize this instrument and so far withdrew more than US$ 2 billion in three tranches.

Legal Framework

With regard to the role of legal procedures in facilitating debt workouts, staff has rightly observed the limitation of bankruptcy procedures in the borrowing countries, and hence referred to an alternative mechanism that may be more effective for bailing in creditors in times of crisis. We would like to point out the experience in the United States which suggests that at normal times only 10 percent of corporate resolution proceedings are done within the court system; the majority of the cases are settled out of court. It is in this light that a more elaborate framework such as the London Approach and the Jakarta Initiative is warranted.

During the last few months after the Jakarta Initiative was established, the settlement of financial disputes between creditors and borrowers leading to successful corporate restructuring have been effected in 10 cases worth more than US$1 billion. In addition, 5 additional cases have already reached the stand-still stage, while 144 other cases have been in the process, with the amount of debt to be settled totaling over US$ 20 billion. This performance is to be contrasted with the unsatisfactory court proceedings which apparently require more time to make any necessary adjustments to the newly established commercial court system.

On this note, my Indonesian and Thai authorities would like to put on record their sincere appreciation for the staff, especially from the Legal Department, who have been actively involved in setting up the modern bankruptcy proceeding both inside and outside the court system.

In general, this Chair is of the view that all kinds of market-based mechanisms merit further examination, even though they may not be able to apply to all circumstances or involve some degree of risk. However, unilateral actions taken by the authorities are not to be left out, if circumstances warrant certain mandatory measures to keep private money from flowing out of the country, for example, short-term capital controls, temporary and selective suspension of debt payments, and temporary stay on creditor litigation. Of course, none of the mechanisms under our consideration is meant to be a substitute for strong adjustment program; it will only help provide the country experiencing balance of payment difficulty with additional breathing space. Above all, we see a need for the Fund to work closely with such fora as G-22 in an attempt to design appropriate and workable mechanisms that would facilitate more active involvement, and burden sharing, by the private sector. In so doing, we need to consider core factors, such as rules and standards that would provide equal footing for all market players, supportive legal procedures, and certain basic principles, for example, cooperation, burden sharing, mutual benefits, and information sharing.

Mr. Lushin and Mr. Palei submitted the following statement:

The new set of staff papers describe in details the current understanding of the menu of available options for involving the private sector in forestalling and resolving financial crises. While many of the issues have already been discussed at the Board, the staff introduced several new elements into the general picture, including the discussion of provision of guarantees by multilaterals, a section on the pitfalls of bond restructuring, and a section on debt monitoring. It is evident that now the papers cover most of key areas for involving the private sector in forestalling and resolving financial crises.

It is time now to take further and more aggressive steps from preparation of a comprehensive overview of the suggested measures toward their implementation. The last column of Table 1 hints of the possibility of an analysis from the perspective of the responsible authorities. We would recommend further developing this analysis. Firstly, it should concentrate on the current and possible role of the Fund in the implementation of each particular measure. In each case, such analysis should answer the questions: (1) What the IMF is already doing? (2) What additional steps could be taken by the Fund without waiting for other participants? (3) What the Fund could do to facilitate decision making by other bodies and by national authorities? Secondly, all measures should be ranked according to their feasibility. And in implementation emphasis should be placed on more pragmatic steps. It would not be reasonable to expect any major break-through with regards to involving the private sector in forestalling and resolving financial crises. Therefore, progress should rather be viewed as a sequence of measures in different areas.

Given the need to concentrate on the implementation of the proposed menu, we would like to express the opinion that, after the discussion of capital controls, one more discussion of private sector involvement with the emphasis on implementation and the corresponding role of the Fund, is called for. It could, probably, be combined with the earlier envisaged further discussion of CCLs.

We would like to comment on some of the specific issues raised in the staff papers, in particular, on the measures to dampen excessive short-term capital flows, on contingent financing of emerging markets, and on debt workouts.

One can hardly deny the evidence that short-term capital flows increase the vulnerability of an emerging market economy to changes in investors' sentiments.

On the supply side of short term flows (Greenspan proposal), the Basle Committee and the regulators in the industrial countries are the main driving forces. The Fund should certainly encourage this process and could probably become a conduit for the opinion of its membership on the desirability of these changes. Calls for the Fund to perform the function of a rating agency are often associated with the above proposals. Indeed, it is not a straightforward task to decide what risk weights should be assigned to a particular country or group of countries. Should these weights be the same in all countries, and, hence, facilitate the use of the same banking standards, or should they differ across countries and be determined by national regulators? In our opinion, the Fund should not perform the role of a rating agency, since it is likely to jeopardize the quality of consultations with authorities and, consequently, the quality of the Fund's advice.

As for the demand side, the discussion of market-based capital controls is scheduled for next week. Predictably, the opinions of the Board will again be split. We are in favor of a pragmatic approach in this area. It should be up to the authorities to choose the appropriate root here. If authorities opt for the use of controls to discourage short term capital inflows, the Fund could take a neutral stance and should be armed to provide the necessary technical assistance in this area. At this stage, it is already clear, that at least some countries will try to imitate the Chilean experience; and, instead of alienating these members, the Fund should remain constructively involved in their activities, and should guide such countries so that they avoid the most distortionary measures.

7. In our view, there are clear links between the use of contingent credit lines extended by the private sector, by official bilateral creditors, and by the multilaterals. The involvement of official creditors and multilaterals, in turn, can be in the form of direct credit lines or in the form of guarantees. Unfortunately, these issues are not sufficiently linked in the staff papers. For example, the pilot project at the World Bank on provision of policy-based guarantees is separated from the private credit lines and there is little discussion of a possible relationship between the two. The lack of discussion on CCLs, or, as we see it, of the precautionary SRF, is understandable, since the corresponding meeting on the CCLs was scheduled after the staff papers for today's Board had been distributed. Moreover, the CCLs are not mentioned in conjunction with contingent financing by the private sector. It would be preferable if the staff entertained different options in this area in more detail. What should be the relationship between private, official, and multilateral contingency financing? Is the proportional participation approach feasible? Should the terms of contingency credit lines (especially the maturity of the loans) at the IMF and in the private sector be similar?

The emphasis on facilitation of debt negotiations, in case such need arises, is well placed. We agree with the staff's arguments in favor of a case-by-case approach to debt workouts. We see little room to incorporate ex-ante into the contracts the possibility of any specific terms of debt restructuring similar to mandatory haircuts. As a general rule, changes in the terms of the contracts should be reflected through market-based means, such as call options. The issues of pricing of such options and similar clauses and their availability in the markets are basically empirical questions and evidence in this area is still very limited.

As far as the IMF's role is concerned, the Board has already made a determination that IMF lending into sovereign and nonsovereign arrears could be considered and applied on a case by case basis.

Similarly, there is little doubt that the improvements in bond contracts with a view to including majority decision rules and sharing clauses, is desirable. We call on the industrial countries to take the necessary steps to make these clauses a generally acceptable practice.

We agree with the staff's views on the potential pitfalls of concerted rollovers of trade financing and interbank credit lines. We also think that the experience of Korea is rather unique due to the low level of public debt in relation to GDP and the concentration of loans in the banking sector. The most valuable in this sense is the experience of Brazil, which is, probably, still too sensitive to be described in the staff papers. At the same time, it is no secret that initially the authorities and the Fund were very reluctant to proceed with formal negotiations. Multiple statements were made in order to dissipate banks' expectations of a concerted rollover. Still, problems with rollover of debt continued and, eventually, the authorities were forced to approach the banks anyway. This episode should be very instructive for the design of Fund policies. Overall, in our view, the Fund's involvement in concerted rollovers should be very rare.

Mr. Cippá submitted the following statement:

The discussions in numerous fora on the involvement of the private sector in forestalling and resolving financial crises over the past year have all come to two similar conclusions. First, a strengthened international financial system must include measures to ensure adequate private sector participation in dealing with today's financial crises. Since the Mexican crisis, the IFIs have had to respond to sudden losses of market confidence by providing substantial amounts of financial resources. These actions have led to widespread criticism as to the lack of burden sharing and the ensuing increase of moral hazard, and are obviously not sustainable in the long term. Second, effective involvement of the private sector requires a delicate balancing between relying on market incentives and resorting to more coercive measures. This issue is extremely thorny and difficult tackle. Having this in mind, it is not surprising that answers are emerging only slowly.

My authorities share the staff's view that finding ways to involve the private sector will be more evolutionary than revolutionary. This, however, should not provide us with an excuse to continue with endless deliberations. Obviously, measures to bail in the private sector come at a cost, either directly in terms of more expensive capital or indirectly in terms of a more difficult capital market access. In my view, this should not discourage us from moving ahead. My authorities are convinced that such increased costs would be more than offset by the potential benefits in terms of correcting existing distortions in risk perceptions, which have led to excessive reliance on short-term lending. The future role of the Fund hinges on finding appropriate solutions on adequately involving the private sector in a more systematic way in forestalling and resolving financial crises. My authorities are not prepared to endorse a continuation of the practice of official financing of large capital outflows.

Prevention and ex ante measures

Prevention must certainly be the first line of defense. While hardly anybody will disagree with this statement, there is still much scope for emerging markets to implement the relevant measures. A better monitoring of capital flows as well as the sovereign and non-sovereign debt is certainly crucial. Given the importance in past crises of debt structures that are skewed toward the short end, debt composition must be more carefully monitored with regard to maturities. The Fund must give particular attention to these issues in the context of its surveillance and of use of its resources.

Regarding ex ante measures, in my view, countries should seek a stronger reliance on voluntary market-based approaches. Among them, private contingent lines are probably the most feasible, even though it is not clear, due to a lack of experience, whether they would provide additional financing during a crisis. While the decision to pay the price for this kind of insurance must be left to the countries concerned, we should seek ways to provide appropriate incentives to encourage a broader use of private contingent lines. In the recent discussion on a possible contingent credit line (CCL) provided by the Fund, like many others, I underscored the crucial importance of having a secured participation of the private sector in any sort of CCL. The requirement of having private contingent agreements could go a long way in this direction and represent a strong incentive for possible candidates to seek such agreements at an early stage.

As regards concerted debt roll-overs, these have achieved some good results in the past. However, their success depends very much on the circumstances of each single case. I concur with the staff that the positive results in Korea cannot be extrapolated to other cases. Brazil is providing us with another case, in which roll-over "animals" with different degrees of moral suasion and public profile are being tested. While this form of bail in has the big advantage of being completely voluntary, the stress test has yet to be absolved.

The problems of bond clauses in order to facilitate the restructuring of international sovereign bonds were well analyzed in the last staff paper on private sector involvement issued in August 1998. The merits and drawbacks of such clauses are well known. However, due to the collective action problems involved, action must be cooperatively taken by groups of debtor countries such as the G-10.

Extreme situations

In the list of proposals to involve the private sector in para. 50 in the staff paper, only a few depend mainly of action by the Fund. One is the handling the so called "extreme situations." If both prevention and efforts to reach a voluntary debt restructuring have failed, countries may be forced to default on their sovereign debt. This would leave the Fund with two options: Either it could stop lending to the respective country or it could consider lending into arrears. However, lending into arrears must only be applied when and if there are firm indications that the sovereign borrower and its private creditors are negotiating in good faith on a debt restructuring plan. If this process has not begun yet, we believe that the possibility of a temporary stay on creditor litigation decreed by the Fund might provide us with an effective measure to ensure a more orderly workout in an environment characterized by heterogeneous creditor communities. As I have stated in previous discussions, we should therefore explore the merits and drawbacks of a possible imposition of such a mechanism in greater detail.

Mr. Hansen submitted the following statement:

The paper is a welcome addition to the existing literature on private sector involvement in forestalling and resolving financial crisis. As a stock taking exercise, it provides a good description of where we are and what needs to be done. However, like its predecessors, the paper falls short of providing any new or magic solutions for involving the private sector. Hence, the core problem "how to keep the private sector on board in times financial crisis" remains unresolved. While I believe we must continue to search for the cure, I can identify with Mr. Guzmán's sentiment that "to some extent we are moving in circles."

In the meantime, I support the thrust of the staff paper and agree with the general notion that the private sector should be more involved in the prevention and resolution of financial crises. I can also agree that practical solutions appear to be more evolutionary than revolutionary, although I am concerned about the evolutionary process being too slow to be useful in the short-run. We actually need commitments from the private sector even as we speak. The ex ante measures discussed go some way toward resolving the problem and I can certainly support these, including the G-10 proposals for modification of bond contracts and the more extreme possibility of amending Article VIII, Section 2 (b) in order to facilitate orderly litigation.

Nevertheless, I prefer that private sector participation be on a voluntary basis and that incentives for participation primarily take place through strengthening the pricing mechanisms of international financial markets. The problem with non-voluntary measures is primarily negative side effects, including incentives to jump ship in times of crisis. In the interim, the Korean model of concerted rollovers with a touch of moral suasion may provide the middle ground between purely voluntary participation and controls. However, there is a problem with using moral suasion over and over again. One valid point of view is that domestic supervisory agencies in creditor countries are potentially put in a difficult situation when faced with a choice between preserving the financial health of domestic institutions or rescuing foreign institutions and the international monetary system.

As we go forward a choice must be made between the present practice of ever larger financial packages, which appears to be developing in the direction of lender-of-last-resort, or prizing risk properly. As Mr. Bernes and Mr. Wijnholds, I clearly prefer the latter option as I believe the private sector is capable of developing suitable instruments if it is not crowded out by official financing packages. The Fund should stick to its catalytic role.

The following refers to paragraph 50 in the paper:

Bullet one: While reviewing the Capital Accord, I encourage the Basle Committee to keep in mind the Greenspan proposal, i.e. to increase the price of short-term debt by making borrowing banks' required capital also dependent on the nature of their funding, and by increasing the capital charge through the assignment of a higher risk weight than under the Basle Capital Accord. The Fund could present its view on this issue during the forthcoming consultative procedure for the Capital Review.

Bullet two: With more and more bondholders in the group of creditors, the likelihood of creditors taking a litigious approach is increasing. Modification of foreign sovereign bond contracts, i.e. to include sharing clauses and collective action clauses, is desirable, and should be encouraged. However, the legal complexities of introducing such contract clauses across countries cannot be ignored. I therefore favor that the Fund initially examines in more detail how voluntary agreements can bring about increased involvement of the private sector.

Bullet three: It is worthwhile to explore further the possibility of arranging contingency financing facilities. While I generally agree with the suggestions put forth in the paper, I believe it is up to the private sector to design suitable instruments and this is definitely an area where evolution does not come to an end. In this context, I also think it is worthwhile to keep an open mind to the concept of credit enhancement contracts. While I would generally oppose the concept of guarantees, I can not be sure of the added value of credit enhancement at this stage. I think it all depends on the risk assessment involved and the architecture of such instruments.

Bullet four to six: In general, I agree that the public sector can improve the environment for private decision making, enhance the flow of information, strengthen debt monitoring and have more regular contacts with the private sector. On this point, I think it is also important that borrowers maintain regular contact and build credibility with the financial community, as suggested by Mr. Dallara of the IIF. Moreover, I think we should keep an open mind to the idea of creating creditor-debtor councils in order to enhance private sector involvement, as suggested by Mr. Yoshimura.

As a final thought, I am somewhat disappointed that the paper does not add much operational content to the goal of involving the private sector. Like Mr. Yoshimura, I believe it is time to adopt a more practical approach to this issue, and as Mr. Guzmán, I think it is time to come forward with more concrete proposals in areas that are clearly within the Fund's domain. I believe Mr. Wijnholds has provided us with some useful suggestions how to proceed. In that context, it might be spelled out clearly which institutions should be in charge of bringing various proposals forward. Moreover, it is important to clarify the framework for crisis management, including the role of different institutions.

Mr. Kiekens made the following statement:

The question of how to obtain the cooperation of the private sector in averting financial crises or resolving them when they occur has been studied intensively for the last four years. After the Mexican crisis of 1995, the G-10's report on sovereign liquidity crises proposed inter alia introducing into bond contracts sharing clauses and provisions allowing collective representation and modification of terms by qualified majorities. Last August, the staff listed and analyzed other suggestions in a Board paper, and later the G-22 Working Group on International Financial Crises weighed in with a paper on the subject. There is now a wide array of options to be considered. It is time for the international community to decide which proposals are most promising and examine what conditions must be met for their implementation. The Fund should concentrate on the actions that fall within its competence and mandate.

Today's discussion should have two objectives: first, to determine which options deserve further study; and second, to see how the options chosen might be related to the creation of a new Contingent Credit Line (CCL), as many Directors including myself requested last week. Accordingly I will comment on the options listed by the staff, and on how some of them can be made a condition for the access to the Fund's newly proposed CCL.

I can accept, with certain caveats, most of the proposals listed in Table 1 and on pages 10 and 11 of the staff paper. However, I cannot support the official enhancement of new debt as part of a strategy for involving the private sector because it runs counter to the goal if sharing the burden of a financial crisis with private institutions. To be sure, it can be instrumental in resolving a crisis, as the Korean case illustrates. But it is misleading to present it as part of a strategy for sharing the burden with the private sector, since its central element is a state guarantee that shifts the burden of risk from the private to the public sector.

Market-based capital controls can help decrease the exposure of emerging market countries to sudden reversals of short-term capital flows, provided they are part of a larger package of economic and financial policies aimed at stability.

CCLs have been used by countries as a means of prearranging access to financing from private creditors in times of crises. Supposing that the Fund does create its proposed new CCL, parallel private CCLs could be made a condition for access to a Fund CCL. Requiring parallel lines of credit would provide a good test of the markets' acceptance of the Fund's eligibility criteria for CCL access. If a member seeking access to a Fund CCL is refused a private CCL, it means that market participants consider the Fund's terms too soft. Hence, this idea is attractive. However, it raises delicate questions about the relative sizes of the IMF and private line of credit. I think that Mr. Wijnholds' idea of setting an indicative limit on the part of the financing gap that in principle can be financed by the Fund may also provide guidance for deciding on an indicative ratio between Fund CCLs and private CCLs.

The staff believes that embedding call options in interbank credit lines may not be feasible because these modified interbank credit lines are unattractive compared with standard credit lines. And indeed, such options are not found in interbank credit lines. Of course, compulsory introduction of a universal debt roll-over clause in all foreign-currency lending, as proposed by some academics, would eliminate the problem, but it would be unrealistic to expect that the necessary consensus could mustered soon. In fact, such mandatory option for rolling over bank credit lines which the government activates for the benefit of the domestic banking system in times of severe balance-of-payments stress is equivalent to the imposition of exchanger restrictions temporarily prohibiting payment of foreign currency obligations.

The presently ongoing concerted rollover of Brazil's interbank credit lines has many attractive features. Its success is a prior action for the release of next tranche of Fund credit to Brazil. It was been arranged directly with Brazil's main creditors by the Brazilian authorities, acting in close collaboration with the Fund. Due care has been taken to consult more or less simultaneously with all of Brazil's major creditors. This is a clear improvement over the consultation with Korea, where the national monetary authorities were forced to play an active role that conflicted with their prudential duties, and where information was less openly shared with creditor banks, at least initially.

The modification of bond contracts to facilitate voluntary workouts in times of crises, could promote the orderly restructuring of new international bond, as recommended by the G-10 over three years ago. But market participants are reluctant to accept such changes: creditors fear that it will lessen the incentive to honor debt contracts, and debtors fear that it will increase the cost of funds. Inserting collective action clauses in bond contracts requires leadership from the official sector, perhaps even changing the laws governing bond issues in major financial centers, which I still support. Here is another area where it would be most useful to develop an international standard.

In extreme cases where voluntary restructuring cannot be achieved, it may be impossible to avoid a default on sovereign obligations or the imposition of exchange controls leading to an interruption in nonsovereign debt service. I also continue to support extending the scope of Article VIII, Section 2(b) of the Fund's Articles of Agreement to capital movements, as a means of promoting the orderly workout of a financial crisis under such worst case conditions. The imposition of temporary, nondiscriminatory exchange controls in such extreme cases should require the Fund's approval, and in consequence be upheld in the legal orders of all member countries.

As the Board decided earlier, the Fund can lend to countries with arrears on their external public debt, even debt in the form of bonds; or to countries that impose exchange restrictions prohibiting payment of private debt in foreign currencies. However, such lending requires the Fund to be satisfied that the authorities are negotiating in good faith a mutually agreeable debt restructuring with the country's creditors, avoiding discriminating among them, and that they limit the size of the default or exchange restrictions to what is unavoidable due to the size of the financing gap and the need to prevent extreme disruption of the functioning of the state and of its economy.

Responding to a question from the Acting Chairman, Mr. Kiekens stated that he was proposing that Article VIII 2(b) be amended to cover capital flows, as the existing language only covered current payments.

Mr. Fernandez made the following statement:

Let me first commend staff for their two papers which provide the basis for a good discussion on this complex issue, although it could have been useful to develop a typology providing some criteria to guide our actions in different situations. This is not to say that we favor a rigid framework: on the contrary, a pragmatic approach is warranted, building on our experience. I agree with the basic principle that there is no silver bullet, but, like many others, I am strongly convinced that limited steps can and should be taken to more effectively bail in the private sector, for reasons I do not need to develop. The time has come to clearly identify these steps and to do what is necessary to go ahead. Like Mr. Kiekens, I hope this meeting will provide a clear picture of the practical agenda with priorities and actions to be taken in the short term, and I must say I was encouraged by the reading of the Grays: there is in fact some points of consensus we can build on, if we act with method. As a general comment, I have no difficulty in endorsing the central lessons identified by staff in paragraph 4, although the emphasis put on the contagion factor seems somewhat overdone. Moreover, the fact that measures under scrutiny might increase the cost of borrowing should not be the sole reason to reject them. I will now comment on the paper's main issues.

Prevention

Everybody agrees that prevention must continue to be the first line of defense. Here, the Fund needs to take the lead and promote speedy progress on three points:

- first, encouraging members to put in place systems for frequent monitoring of private external liabilities;

- second, finding ways to limit the expanding use of put options in sovereign debt instruments and to encourage members to maintain an appropriate debt structure. This could be done through the Article IV process;

- third, fostering an effective communication between emerging market borrowers and capital market participants. I was disappointed that this point was not more developed in the staff report, for it raises important and sensitive issues. A number of suggestions were made following previous discussions in the Board where this chair had made some proposals, for instance by the Institute of International Finance in its January 99 report on financial crises, or by academics in various post-Asia agendas. Like other Directors, I would therefore appreciate further thoughts and comments on this issue.

Lastly, we should encourage the Basle Committee to bring to a timely completion its work on the so-called Greenspan proposal aimed at discouraging short-term borrowing.

Facilitating the private sector's involvement in forestalling and resolving financial crises

As regards measures aimed at facilitating the private sector's involvement in crises, the Fund should encourage progress in the two following directions:

- first, encouraging emerging market countries to arrange contingent lines of credit with private banks. Despite their inherent limits, well described by Mr. Guzman in his Gray and the limited appetite demonstrated by private sector actors, these contingent lines provide a first tool worth encouraging ;

- second, promoting the recourse to British-style clauses in international sovereign bonds. On this matter, although I agree G10 countries should give the example, I am not sure we should necessarily endlessly wait for them. We are running the very high risk of seeing Barry Eichengreen's "After you Alphonse" problem persisting, if we maintain this stance. In addition, I would appreciate further information from staff on two points: first, on the legal status of the most recent emerging market bonds; second, it would be helpful to have a somewhat systematic analysis of the pricing of bonds issued under the UK and US models. More generally, we will have to return to the issue of bond restructuring in a crisis situation and to the role the Paris Club plays in this regard, in its operational and informal setting.

On other possible avenues, while debt-service insurance schemes may be worth further analysis, I share the staff's doubts on the practicality or desirability of call options in interbank lines, and on proposals to have recourse to official enhancements of new debt, including through international financial institutions. On this last point, the French chair will confirm its concerns and doubts in the World Bank this afternoon, and I will later today circulate our technical note on this issue to Fund Directors for their information.

On the critical issue of concerted rollovers, I agree with the staff's main findings regarding our highly diversified recent experience. I am nevertheless of the view that the extreme caution we supported in the Brazilian case in 1998 was an error, and that we lost an opportunity to be more pro-active, a policy we are now endorsing. In addition, the issue of burden-sharing between domestic and foreign private investors is yet to be properly addressed, (Mr. Wijnholds's third caveat). We will have to reflect further on these issues.

Finally, when extreme situations are involved, I do not share the view, expressed by some Directors, that standstills should be trivialized. It should be clear that such a move is a last resort solution. A more cautious wording would be even more important if the paper were to be made public, a move we are ready to support.

Also, several important issues will have to be discussed further, such as the Fund lending into arrears strategy and the possibility of amending Article VIII, Section 2(b). At this stage, I would just like to say my authorities remain to be convinced of the necessity of such an amendment and of the opportunity of granting the Fund the authority to sanction requests for standstills.

One last word on the related subject of the Contingent Credit Line: as this chair stated last week, I would suggest that most of these options be included in a kind of checklist which would be used in assessing a member's eligibility for the CCL: private sector lines of credit, limited recourse to put options, introduction of British-style clauses, ongoing monitoring of private external liabilities and an identified framework for private sector implication should be part of the picture in assessing eligibility under the facility.

Mr. Wei made the following statement:

I welcome today's discussion about involving the private sector in crisis prevention and resolution—one of the most important questions that the international community has to tackle. Yet, progress is limited in this aspect. While we see the official community pushing for the adoption of initiatives in various areas, such as transparency in the official sector, corresponding progress in pushing for private sector involvement is lacking. I hope this will not be misinterpreted as the official community's inadequate resolve to ensure the private sector bears its fair share, although noting that private sector involvement is a complicated issue. Nevertheless, the staff's suggestion to focus attention on several workable approaches is an important step forward.

The staff have concerns that measures to involve the private sector could lead to reduced inflows and higher borrowing costs at normal times, but one has to strike a balance to ensure more appropriate risk assessments by investors and the reduced likelihood of excessive capital inflows. The concern of certain measures on the contagion impact is more troubling. So there is cause for caution in implementing those proposals, by carefully weighing their cost and benefits.

Turning to more specific proposals.

The modification of bond contracts merits consideration and the major industrial countries should take the lead in modifying sovereign bond contracts in order to set the international standard. This should encourage emerging market borrowers to take actions to allow for the orderly restructuring of bonds. Members may also explore the possibility of arranging contingent financing facilities as well as structured instruments to float against economic developments.

Further progress in standards and transparency should, in principle, help improve the environment for efficient private sector decision making, and I look forward to forthcoming discussions in these areas. Nevertheless, much has been said about the disclosure of the official sector. I wonder what the progress is on private sector transparency, which should also be a factor contributing to more efficient decision making as well as risk taking by the private sector. In this connection, I share the views of Mrs. Hetrakul, Mr. Eyzaguirre and M. Zoccali on the need for greater transparency of financial institutions such as investment banks and hedge funds.

There is merit for effective communications between debtors and creditors under normal circumstances, but it seems to me that borrowing countries, in fact, maintain close dialogue with their creditors at most times. Can the staff be more specific on this bullet point?

I agree with the staff's emphasis on the better monitoring of private capital flows. The monitoring system of the banking sector's external liabilities put in place by Fund staff in several crisis countries has demonstrated its usefulness. However, the system cannot capture the full picture in case interbank lines do not constitute the main part of the story. Can we have more data from the creditors' side to complete the story? Can we have a more comprehensive monitoring system developed in normal times? The staff's comments are appreciated.

Appropriate debt management by country authorities is clearly an important issue in preventing a crisis. Sovereign borrowers should try to limit the use of any acceleration clauses in bond or loan contracts and actively manage the term structure of their debt. The banking sector's external liabilities, including its maturity structure and net exposure, are subject to the regulation and monitoring of the supervisory authorities. There remains a question on how governments can ensure an appropriate debt structure (in terms of both size and maturity structure) of the nonbank private sector if they are allowed to borrow from abroad. Here, I believe there is a role for some capital controls or other form of regulations to govern the external borrowing of the private sector. I look forward greater discussion in the forthcoming Board meeting on this area.

On official enhancements of new debt, this seems to be a useful innovation to leverage official capital. I generally share Mr. Yoshimura's arguments on the official guarantee scheme. If used carefully, this should avoid any crowding out of direct official lending. One must recognize that public money may not be sufficient to fill the large size of the financing gap left open by the private sector. Debt enhancement is a possible avenue to engage the private sector, by allowing countries to access private capital at a more reasonable cost, and rebuild the confidence of the private sector. We are just beginning to accumulate experience for using this instrument. Perhaps we should be more open-minded about this proposal.

On concerted rollovers, the staff have highlighted some possible negative effects and argued that it might not work in every case. Nevertheless, foreign banks' maintenance of credit lines is essential to the success of the program and confidence building, as in the case of Korea. While a strong adjustment program is important for a country to build a basis for recovery, the rollover of interbank credit lines can be critical to a rapid turnaround of investor confidence under a crisis situation. How to ask banks to roll over their credit lines is a delicate issue, but this does not diminish the importance of this element for the success of an adjustment program.

I agree that effective bankruptcy procedures can help bail in creditors and facilitate the restructuring of viable but insolvent corporations. Technical assistance in this aspect should be provided to members.

Under extreme circumstances, members may need to impose exchange control and/or exercise a default on sovereign bonds. I believe no member would really want to go down that road, but would more likely be forced to undertake those measures under very difficult circumstances. However, on the question of sanctioning a temporary stay on creditor litigation, this is an issue which needs careful deliberation. I look forward to the staff paper which further discusses this.

Many of the proposals are under discussion in various fora or institutions. Close collaboration and discussion among various bodies, including the Fund, the Bank, the BIS and so on, would be useful. The Fund staff should keep in close touch with other institutions on the development of these issues.

Lastly, I hope that the international community can demonstrate their resolve and take concrete actions to ensure proper and fair burden sharing by the private sector.

Mr. Donecker made the following statement:

First, I thank the staff for a useful, condensed survey of where we stand. The past 18 months has produced a broad-based consensus that private sector involvement in the prevention and resolution of financial crises is indispensable—not only to provide the right incentives for market participants, but also to protect the catalytic role, financial integrity, and credibility of the Fund. Like Mr. Bernes and others, I would argue that, if the international community reaches an agreement on some of the measures discussed in the staff paper, the private sector can be bailed in and widespread crisis can be averted. The role of the official would be as an honest broker, advisor, and financial catalyst, and not necessarily the provider of large financing.

Many proposals have been envisaged on how to include the private sector in forestalling financial crises, but little concrete progress has been achieved so far. After extended consideration of this complex issue in a number of international fora, it is time to come to grips with the problem, and to move forward in those areas that have produced a broad consensus.

As the staff has reminded us, decisions and actions in this area are the responsibility of several players; i.e. creditors, debtors, and the Fund. Given the Fund's mandate and role in the international monetary system, we should endeavor to provide guidance and momentum to the global search for sensible mechanisms to ensure adequate private sector involvement. I have the impression that the staff has tended to wait for too long for practices to develop and evolve. The international community expects the Fund to provide leadership. Therefore, my concrete proposal would be to agree on an action plan with the objective of proceeding in those areas where the Fund has primary responsibility, and providing strong encouragement to those institutions with responsibility in other relevant areas

Having said this, I am of two minds on the staff's proposal to publish the two documents before us. Especially as we still are in the midst of this discussion. I do not like having such surprises without a clear need for an a quick decision. Is it too much to ask that the Board receive earlier warning about the staff's intention to publish important market-sensitive texts such as these? I, and most likely my authorities, would like to have a second look at these texts before agreeing to their publication, particularly as the staff's analysis seems to have to overemphasized the potential risks. Tempted as I am to agree to publication, I nevertheless believe it necessary to give our authorities a few days to ponder this proposal. The Board should then address the issue again, perhaps at next Wednesday's meeting.

As for the Fund's approach to private sector involvement, it is crucial that the Fund, in its own decisions, provide clear signals to members and to the markets that its participation in any crisis resolution will depend upon appropriate involvement of the private sector. Otherwise, there will be a risk that bailout decisions of the Fund, albeit often in extraordinary circumstances, will permanently affect the expectations of investors and authorities, and so increase the risk of a new crisis occurring. We have to reestablish, and promote, better rules of the game. We are concerned about certain expectations that the Fund will take on the role of a lender of last resort. This is counterproductive. It undermines any serious or credible attempt to involve the private sector more effectively. The Fund cannot be a lender of last resort and it should not aim to become one.

Before coming to specific measures to involve the private sector, let me briefly comment on the debate covered in paragraph 4 of the staff report. First, we concur fully with the principle that contracts should be honored. However, we have to bear in mind that it cannot be the general duty of the international community to provide the funds necessary to ensure that all contracts are honored in every circumstance, even in those cases where the contract parties have acted recklessly. Second, the assertion that improvements have to be evolutionary rather than revolutionary should not allow further delay in ensuring the involvement of the private sector. This principle should not be used as an excuse to settle for a marginal modification of the Fund's unsustainable policy of large-scale assistance packages. Thirdly, when discussing ways to involve the private sector, the risk of contagion should not be overstated. We have already expressed our doubts about whether there are actually any "innocent" countries being unfairly affected by contagion. Fourthly, in principle, there is nothing wrong with an outcome in which the involvement of the private sector results in a decline in volatile short-term capital flows to emerging market countries, and/or increased interest rate spreads. Members of the Board have often wondered why interest rate spreads no longer seem to reflect individual borrower risk. Thus, like Mr. Bernes and others, I agree that a widening of spreads, leading to a more efficient allocation of capital, should be regarded as a desirable contribution to international financial stability, and that notion seems to appear in another section of the staff paper.

Turning to mechanisms to involve the private sector. Given that every case may be different, and that an appropriate involvement of the private sector normally will require a broad set of measures, the actual mechanisms used will depend on the specific circumstances of a country and the resultant probability of a crisis—particularly the structure of creditors and debtors and the nature of the credit instruments they have chosen. In the end, it is crucial that the Fund's and the private sector's resources are used in a way that respects and ensures the catalytic role of the Fund. If, for instance, the bulk of the problem concerns private sector debtors and creditors, the private sector should generally bear a correspondingly greater share of the solution's risks. Generally speaking, most measures described in the staff paper are suitable for bringing about a stronger involvement of the private sector—even though some may entail larger risks of an adverse market reaction than others. Like Mr. Bernes, I concur with the staff that prevention is the key . It is crucial, for instance, to maintain effective communication between borrower counties and their private creditors, and to maintain measures to strengthen debt monitoring as well as proper regulation and supervision of banks and other financial institutions. Other important measures include: a well-functioning judiciary, effective bankruptcy legislation, and appropriate prudential measures as outlined in the Greenspan proposals. Furthermore, we need increased transparency of private and official debtors and their governments.

Against the background of our discussion on a contingent Fund credit line, ex ante measures that can be put in place before a crisis occurs are particularly valuable. Private credit lines, as well as call options in interbank lines, are useful and effective instruments. I do not share the doubts of staff, as I do not see why the design of the trigger mechanism should be more difficult for call options than in the case of private credit lines. In both cases, the trigger could be the activation of Fund credit.

We also believe that private debt insurance could be a helpful instrument, and it is difficult to understand why markets have not explored this area. In particular circumstances, debt service insurance, as well as official guarantees of new debt, may also be options that could be considered. I am, however, more skeptical with regard to official guarantees, as they always interfere with incentives.

Voluntary rescheduling agreements should be the center of a strategy involving the private sector in crisis resolution, complemented by moral suasion by the international community and national authorities if needed. This strategy proved successful in the case of Korea. Against this background, however, I wonder why this option is not included in staff's concluding observations. The staff seems to believe that Korea's success was due to unique circumstances, and that it would be difficult to replicate. Furthermore, the staff expresses more general concerns on the systemic consequences of concerted rollover and restructuring operations. I am not convinced by the staff's reasoning. First, the possibility that rollovers may not work in individual cases is not a good enough reason not to consider the option. Second, it remains unclear why the use of this option should be strictly limited to cases where a default is imminent. Finally, we are not convinced that the relatively low rollover rates for Brazil in October of 1998 were the result of the banks attempting to exit before getting caught up in a concerted rollover. Instead, the protracted program negotiations and expected weaknesses in the program design—resulting from the authorities' insistence on maintaining an exchange rate regime that the markets viewed as unsustainable—might have played a major part.

I urge the staff to focus on the necessary framework to ensure that, in future crises, a concerted voluntary rollover can be initiated before agreement on a Fund program is reached. We need an organizational road map of how all the major creditors can be brought to the table quickly, and a strategy that includes incentives for reaching a rapid voluntary agreement on rollovers or rescheduling. The existence of efficient bankruptcy procedures in the borrowing country would be helpful.

In extreme situations, if efforts to reach agreement on voluntary debt restructuring fail, we concur with the staff that members may need to consider some combination of default on sovereign bonds and imposition of exchange controls— measures that would lead to an interruption in the ability of non-sovereigns to service their external debts. In general, we are also prepared to consider a temporary stay of litigation. Moreover, I share the staff's view that the modification of sovereign bond contracts to include a collective action clause could make a significant contribution to orderly workouts, while creating a more level playing field for all market participants. To sum up, while we agree that the task of encouraging private sector involvement is complex and challenging, we would encourage the staff and management to take a more active role in promoting those pragmatic ideas that have the broad support of the Board. We are fully aware that there is no silver bullet, and that much further work will need to be done before the suggested approaches can be implemented. However, like Mr. Yoshimura, I believe that we should not wait passively for the solution to evolve, but should bring our actions, encouragements and recommendations to other relevant fora.

We have reached the stage where we should implement concrete measures in those areas where consensus exists. To quote Messrs. Yoshimura and Ogushi, if we become too anxious about the risks emphasized by the staff, and less aggressive about increased private sector involvement, the private sector will consider that it is unlikely to be asked to share the burden of crisis management and will continue to make reckless investments. We agree that special emphasis should be placed on appropriate preventative measures, and that the proposals listed in section 51 of the main paper—in addition to further work on an organizational road map, the encouragement of voluntary rollover agreements, and promotion of effective bankruptcy procedures in all member countries—should be pursued as a matter of urgency. Having a critical mass of preventative measures in place should also be one of the eligibility criteria for access to a contingent credit window of the Fund.

In any case, we must ensure that any such contingent credit mechanism does not lead to less, rather than more, private sector involvement in the prevention and resolution of financial crisis. So, without concrete progress on the private sector involvement issue, my chair would find it difficult, if not impossible, to move much further on the CCL proposal. In conformity with former agreements, we see this as an interrelated package.

Mr. Bernes commented that, although the staff papers might have to be amended before being made public, it was important that they be published as soon as possible. In discussion with officials from the Canadian central bank, he had been reminded that there was significant uncertainty within the banking community on the issue, and that they were looking forward to a substantive dialogue. Directors should not wait for a solid Board consensus, but should involve the private sector in that dialogue from an early stage.

Mr. Hansen suggested that it might be advantageous for the Board to have a more direct dialogue with the bankers that had been involved in the recent crises. He also asked Mr. Donecker whether he supported an amendment of the Articles of Agreement allowing stays on creditor litigation.

Mr. Donecker agreed that more direct dialogue with bankers might be useful, and confirmed that he was willing to consider amending the Articles.

Responding to a question from Ms. Lissakers on the importance of contagion, and noting Ms. Lissakers's point that cross-border capital flows to emerging markets had dropped to zero in the third quarter of 1998, Mr. Donecker maintained that countries with sound macroeconomic policies had not been affected strongly by contagion effects. In Argentina, for instance, early corrective action by the authorities had helped maintain market confidence, even in the face of considerable pressure. Although there might sometimes be spillover effects as global investors attempted to offset losses in other parts of the world, countries with sound policies were generally able to attract the financing they needed.

The Acting Chairman raised the analogy of the influenza epidemic in 1918 that killed 40 million people. Although it was true that the epidemic mostly affected weaker individuals, without the disease, many people would have lived much longer. In a similar vein, when market conditions took a turn for the worse, it was those nations with less-sound policies, ex post, that were hit hardest. However, that did not mean that the phenomenon of contagion did not have a major impact on the economic performance of a large number of countries.

Mr. Guzmán-Calafell pointed out that Argentina had lost access to international capital markets at the end of 1998. Further, once access had been restored, the spreads on Argentine and other Latin American bonds had suggested the presence of contagion effects.

Mr. Zoccali said that he agreed with Mr. Guzmán-Calafell's sentiments. Although the markets did differentiate between good and bad policies, that differentiation was often slow. In the meantime, loss of access to capital markets could have a considerable impact on the economies concerned. On the question of whether the staff papers should be published, he agreed with Mr. Bernes's position.

As for the more general issue of private sector involvement, there seemed to be an assumption that the private sector's unwinding of its positions was instantaneous and costless, Mr. Zoccali continued. He suggested that the staff explicitly mention that private sector actors had suffered significant losses when unwinding their medium- and long-term positions.

Ms. Lissakers remarked that Mr. Donecker's benign view on the risks of contagion were somewhat troubling. Although the initial turbulence had subsided, and investors were increasingly differentiating between markets, the effects of contagion were still apparent and continued to distort the global pattern of economic activity. Latin America was not expected to grow at all in 1999, despite the policies of individual countries. Most of Asia was still in recession, producing a highly skewed world-wide distribution of trade and current account balances—the United States was the leading source of global demand and was running large trade deficits to offset surpluses in Asia and Europe. The current pattern was not healthy, and its persistence was due to the lingering contagion effects of the Asian crisis. The cost of the problem was being borne by all countries, not just those immediately affected.

Mr. Fernandez commented that contagion might even perversely impact countries with relatively strong policies. During a recent discussion with a hedge fund employee, it had been explained that, in order to cover its losses in Russia, the fund had unwound some of its position in Hungary, which had been performing relatively well. As for dialogue with the private sector, direct contact between the Board and private sector representatives might be useful. The January 1999 report of the Institute of International Finance had shown that the private sector was reluctant to consider even those items generally agreed upon by the Board.

Mr. Donecker remarked that he had not meant to imply that contagion effects were non existent. However, there was an assumption that contagion was a harmful phenomenon that impacted otherwise innocent and virtuous countries. That was not the case. The countries that had been impacted were those that had not followed sound policies. It had also impacted market participants, but since then, those participants appeared to have been more careful. The objective was to have the markets pay more attention to credit risk, and that seemed to be happening. In 1999, market participants were reassessing their overall approach and were placing greater value on more sound investments. That had led to a contraction in international lending, but it was also a force for change in those countries that had not adopted appropriate policies. In that sense, the market was acting where Fund surveillance had failed. As a case in point, he asked whether the

Board considered the Fund to have exercised firm surveillance over Brazil int he two years prior to its crisis.

The Acting Chairman pointed out that the Fund had expressed its concerns to the Brazilian authorities. However, that raised a further issue as to whether the Fund should make such concerns public. In any event, he did not consider that the main feature of the southeast Asian and Brazilian crises was a failure of surveillance. Further, he cautioned Directors not to assume automatically that the market would produce the correct outcome in all circumstances.

It was true that market participants were too optimistic in their investment decisions prior to the crisis, the Acting Chairman continued. But the process of reassessment was making the situations of many countries more difficult that strictly necessary. Further, although the end result of that reassessment would be a healthier system, there was no guarantee that the markets would not once again tend toward excessive optimism, followed perhaps by excessive pessimism.

Mr. Donecker said that he agreed with the Acting Chairman's skepticism as to the infallibility of markets. However, he recalled that a few months prior to the Thai crisis, the Fund had published a positive occasional paper on that country, which failed to warn the public about any financing or banking sector risks. There were limits on what the Fund could do, but its surveillance efforts needed to be strengthened.

Ms. Lissakers commented that the Fund's challenge was not so much to detect vulnerabilities, but rather to deal with extraordinary and extreme conditions. It appeared that the markets were just as indiscriminate during periods of market unrest as they were during periods of market optimism—as demonstrated by the compression of interest rate spreads during boom periods, and the dramatic widening during periods of crisis. In both cases, there was little discrimination between better credit risks versus weaker credit risks. Domestic financial systems had a range of cushioning mechanisms to limit the damage to the real economy from those types of panics—including greater experience, more tools, and increased legal authority. However, developing such mechanisms at the international level was difficult, particularly in a system based on national sovereignty. In that light, the frustration of many Directors at the pace of the dialogue was perhaps unwarranted. Given the systemic constraints, more had been accomplished than Directors seemed to have realized.

Mr. Donecker commented that the challenge was to develop a set of incentives that led to a more efficient allocation of capital. On inspection, the banking groups of some countries had invested in countries such as Thailand and Indonesia on a medium- to long-term basis. However, the banking groups of others had taken short-term, more speculative, positions. Perhaps the Fund should consider the education of the latter group of investors, reinforcing the message that large short-term profits often entail the risk of large short-term losses.

Mr. Pickford said that agreed that the challenge was to create a system of appropriate incentives for both borrowers and lenders, and he agreed with Ms. Lissakers that the markets seemed to overreact in both directions. The proposals before the Board were an attempt to tackle the problem of excessive volatility and lack of discrimination. However, an appropriate solution might involve higher capital costs for many countries, and a reduced flow of investment. While that was an unattractive prospect for many countries, most had realized that the costs associated with excessive volatility were worse.

As for the notion that there had been more progress than Directors had appreciated, while the proposals had been studied in depth, little had actually been done, Mr. Pickford continued. That was one reason why Directors had urged a pragmatic move forward—implementing those concrete proposals that seemed, on balance, to be positive.

Mr. Giustiniani made the following statement:

> The two additional documents prepared by the staff provide some further insight on the rather controversial issue of how to involve the private sector in forestalling and resolving financial crises. This Chair agrees with the main conclusions of the staff analysis and shares the sense of urgency in proceeding expeditiously to complete the work-program summarized in paragraph 51.
>
> Particular efforts should be devoted to enhancing the efficiency and discipline of capital markets. This can especially be done by improving the process of risk management by market participants. In this regard, the Greenspan proposal merits further consideration, and the set of sound practices for bank's interaction with highly leveraged institutions recently agreed upon by the Basle Committee on Banking Supervision is a step in the right direction. Further developments in this field are certainly warranted and closer coopèration among the supervisory bodies is called for.
>
> As the ongoing debate shows, involving the private sector is -- on all counts -- a handle-with-care issue. It has several facets that have to be carefully considered. But, trying to simplify, one can say that the problem has two distinct dimensions. The first one is technical in nature. It covers the several mechanisms aimed at precommitting private investors to a more "cooperative" behavior in times of crises. Here, the spectrum of possibilities ranges from preemptive measures aimed at discouraging an excessive build-up of short–term, especially bank-to-bank, lending to innovative instruments, such as the use of structured notes; from more traditional mechanisms, such as the establishment of contingent credit lines with commercial banks, to measures advocated but so far never adopted, such as the incorporation of majority-voting, sharing, and nonacceleration clauses in bond contracts.
>
> The second dimension of the problem falls within the more sensitive area of policy -- where caution is always called for. It deals with the core question of what we should do. Although the extent to which private investors have been shielded from losses in recent crises should not be exaggerated, there is a widespread consensus that the existing arrangements for handling crises are deficient. Many observers have underscored the need for exploring possible mechanisms that would

allow a more equitable burden sharing among different market participants. The aim is to overcome coordination failures both among creditors and between the private and the official sector.

On the technical side of the issue, there is little that can be added to the staff analysis. As shown, each one of the considered instruments for bailing in the private sector has its own advantages and disadvantages. From a general perspective, while one can argue that negotiating standby lines of credit with commercial banks is the more viable option in the short-run -- though the amount of resources that can be effectively mobilized may fall short of expectations -- the call for changing contractual covenants may turn out to be a more farsighted alternative -- especially if we believe that the securitization process is not likely to lose momentum. But in this area we cannot go any further than to express a general preference for one instrument or the other. The choice will be a matter of convenience for the involved parties, the result of the typical bargaining process between lenders and borrowers.

This leads me to the second dimension of the problem, namely the policy side. Here the debate is still lively and a clear course of action has yet to emerge. The topic is rather wide and articulated. I will try to focus my comments on those aspects that, I believe, are more relevant for the activity of the Fund. The fact that risk-sharing mechanisms are not provided by the market spontaneously suggests that significant difficulties are present. This market inactivity leaves scope for intervention by the public sector, including the IMF. It certainly falls outside the purview of the Fund to suggest the specific instrument to be adopted for bailing in the private sector (contingent financing, call options, or new provisions in loan contracts). What matters is that, in a period of "clear sky," the involvement of the private sector should be voluntary and the mechanism market friendly. However, a country's desire to negotiate possible risk-sharing mechanisms with private investors can be frustrated by the risk of sending a negative signal to the market itself. For instance, no country will want to renegotiate its own loan obligations so as to facilitate the consultation and cooperation process with the creditor community, because it might signal a lower commitment from the debtor to fully respect current obligations. Hence the market's request for a higher "insurance premium" to compensate for the perceived higher default risk. This situation of stalemate may be overcome if the public sector, including the IMF, provides the appropriate incentives to both sides of the contracting table.

On the borrowers' side, the possible establishment of a new contingent credit line by the Fund may provide such an incentive. Calibrating the terms and conditions of the financial assistance that the Fund could make available through this new window -- among others -- to the success of a member country in "involving the private sector" can jump-start the process. For instance, as already hinted in the last Board meeting on the CCL, consideration might be given to the possibility of increasing the access limits if a satisfactory degree of private sector involvement is achieved and the requesting country has reached -- or significantly moved toward -- a more appropriate debt structure.

On the lenders' side, the incentive should originate from acknowledging that in extreme situations scrambling for the exit might not be the most rewarding strategy because temporary stays on external obligations might be imposed. This remains a very controversial issue and a more thorough analysis is called for. We remain hesitant with respect to possible legal changes that would permit the IMF to implement an automatic stay on the enforcement of creditor claims in conjunction with the negotiation or implementation of a Fund-supported program. This would represent a material change in the prevailing rules of the game and in the current institutional framework. From a general point of view, this Chair continues to consider the recourse to temporary standstills on debt obligations and lending into arrears by the Fund as last resort measures to be adopted in very exceptional circumstances.

Mr. N'guiamba made the following statement:

The current emerging market crisis has brought to the fore the debate on the need to increase the involvement of the private sector in the prevention and resolution of international financial crises. The importance of private sector involvement has become evident in the recent past, particularly in light of efforts to bring some stability to those countries affected by the crisis. At the same time, a number of sovereign and non-sovereign borrowers in some Asian countries, as well as Moldova and Romania, are reported to have had to repay their medium- and long-term debt ahead of their original maturities, owing to the exercise of embedded put options. The involvement of the private sector so far has been achieved mainly through moral suasion by the international community. In our view, there is a need for a mechanism to encourage private sector cooperation in maintaining or providing additional net exposure in times of crisis. In other words, the private sector should be required to share the burden of the costs associated with the solution of such crises. We note the various proposals that have already been made and listed in the staff report.

Before commenting on some of the measures presented in the paper, let me say that countries should be encouraged to take measures on their own to prevent financial crises. It is essential to create a transparent policy and regulatory environment, and to improve the flow of information between emerging market countries and creditors. Such a transparent environment should enable the private sector to better assess risk, and it should improve the efficiency of international capital markets. We share the staff's view that the Greenspan proposal to impose greater discipline on the cross-border interbank market, by addressing the market bias toward short-term financing intermediated through the banking system, should be given serious consideration.

On the measures proposed in the paper, contingent financing through commercial banks represents a useful precommitment by the private sector. We agree with the staff that, if fairly priced, they can provide efficient insurance against adverse market developments. In addition, they will help maintain access to borrowing during periods of stress. However, as staff rightly noted, it is premature to draw definite conclusions from our limited recent experience. In any event, it is clear that emerging market countries should be encouraged to obtain such contingent financing arrangements. They are easy to put in place, and only require debtors to be willing to pay an insurance fee. We recommend that the activation of this arrangement be subject to adoption of sound macroeconomic policies and the establishment of a strong regulatory framework. Ideally, this could be done in connection with a Fund-supported program.

On the official enhancement of new debt, we note that, while it may help mobilize additional finance to emerging markets, there are issues concerning the possibility of excessive accumulation of inflexible debt, thereby creating new problems. Nevertheless, we agree that such instruments could be used on a limited scale at times when market access is very limited.

Finally, we note that, in recent years, there has been limited experience with restructuring of international sovereign bonds and similar instruments. Therefore, we understand that it is premature to draw firm conclusions in this area. We agree with the staff that bond contracts should be modified to include a sharing clauses, modification of terms by qualified majorities, and collective representation provisions.

The Acting Chairman, responding to a query from Mr. Guzmán-Calafell, noted that there had been five Directors' preliminary statements circulated between 5:30 and 6:00 pm the previous day. Two more statements had been circulated after 6:00 pm.

Mr. Donecker recalled that there was a general understanding between Directors that preliminary statements should be circulated by lunchtime the day before the meeting. It might be understandable if some statements arrived late, e.g. 4:00 pm, but it was not acceptable to have preliminary statements issued at 6:00 pm. In order to allow Directors to engage in a more meaningful exchange of views, it was essential that Directors' preliminary statements be issued in a more timely manner.

Mr. Taylor suggested that, for those Directors who circulated their statements after the agreed deadline, it was reasonable to ask them to present a brief summary during the morning of the meeting.

The Acting Chairman suggested that the issue be taken up on another occasion.

Ms. Lissakers made the following statement:

It is obvious that the behavior of private investors will largely determine the timing, scope and duration of balance of payments crises in today's market-based global financial system. But when we talk about "involving the private sector" in crisis prevention and resolution, it is useful to remember that our ability to shape investor market behavior is limited. Greed, fear, peer pressure, inexperience, poor judgment are all human variables official institutions can influence only indirectly particularly in periods of market extremes — financial booms and busts.

It is also important to recognize that the measures we might reach for in a crisis can conflict with efforts to prevent crises. For example, too easily condoning breach of contract or interfering with the right to pursue legal remedies can heighten market volatility and trigger more disorderly and costly crisis responses down the road. That is the other edge of the moral hazard sword. The international regime for crisis response needs to balance the desire to provide for appropriate private sector involvement in crisis resolution with the need to avoid the creation of a financial system where creditors have strong incentives to rush for the exits at the first sign of financial distress.

Finally, I observe that it is the fate of financial regulators to always be playing catch-up with the markets. Each significant regulatory adjustment is likely to trigger a countervailing and often offsetting response in the markets. For example, the imposition of higher capital requirements for on-balance-sheet banking transactions under the Basle Standards encouraged the growth of off-balance-sheet activity. And governments may decree that their citizens should only borrow cross-border long-term, but lenders will embed put options in the loans.

My call for a measure of humility notwithstanding, we should not be too modest about the changes that are already underway. The frustration expressed by many colleagues in their statements is misplaced. It is simply wrong to say that "nothing is happening" vis-à-vis involving the private sector.

Forestalling Crises

With regard to forestalling crises, current efforts are concrete and hugely ambitious with most of the effort targeted directly at private financial actors. The international community is working with great intensity to improve the quality of financial supervision and regulation, to raise corporate and financial disclosure and accounting standards, to increase the equity required to support risky activities and to establish workable bankruptcy regimes. We are also improving debt data and monitoring and working to refine debt management techniques, an area where we would like to see intensified work. Together these efforts will create a more robust international financial system and also limit opportunities for regulatory arbitrage.

And the Fund, working in individual countries, has helped to bring about sweeping changes in banking and banking regulation, accounting disclosure, corporate governance throughout Asia and other parts of the world.

The Basle groups are considering prudential measures to encourage better risk management by borrowers and lenders for improved crisis prevention. While Chairman Greenspan would deny paternity of specific proposals which staff attributes to him, he would certainly agree on the need for greater discipline on the cross border interbank market and the need to address any bias towards short-term bank financing. In this regard, we welcome the comprehensive reassessment of the Basle treatment of credit risk and look forward to the early completion of the work of the task force examining the Basle Capital Accord.

Simultaneously many countries are experimenting with innovative financial arrangements that provide for greater contractual risk sharing between creditors and debtors to reduce the risk that adverse market developments would imperil their ability to meet their contractual obligations in full and on time.

In this context, financial arrangements that provide ex ante private insurance, for example, in the form of contingent credit lines and more flexible payments in the face of adverse shocks could be encouraged, particularly in the context of IMF surveillance. However, such measures may not be appropriate in all circumstances and for all members. Moreover, our experience with such measures is rather limited and it is unclear whether these measures actually result in the private sector undertaking greater risk exposure or simply lead to offsetting reduction in exposure through other channels. In this connection, the reaction of creditors to Mexico's drawing on its contingent credit facility warrants further examination since it provides a concrete case to estimate the level of additionality likely to be provided by such facilities. We also share staff's concerns about the potential impact of put options on a country's payment obligations during periods of stress. With regard to call options or other forms of catastrophic insurance, it would be useful to consider how they could be developed in a manner that addresses the issue of defining appropriate exogenous triggering event that could be adequately priced.

Another self-defense mechanism is the imposition unremunerated reserve requirements on interbank liabilities. However, we should recall Mr. Eyzaguirre's words of wisdom in an earlier discussion that such measures can succeed only for a time and when complemented by vigorous measures to strengthen the financial system and the adoption of sound macroeconomic and exchange rate policies.

Crisis Resolution

Similarly we have been making important case law, carefully, to involve private lenders in crisis resolution, in Korea and Brazil, Ukraine and Pakistan. I stress the word "carefully" because caution is warranted when markets are volatile and when the immediate problem we face is not too much lending, but too little, and the severe constriction of private international financial flows is impairing the ability of even healthy emerging market economies to grow.

Going forward, if and when crisis strikes, we believe that policy responses vis-à-vis the private sector should be guided by the following principles. First, countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. The law and market mechanisms provide strong incentives for countries to meet their obligations, and official actions should reinforce these. Markets cannot function well without a well-functioning legal order in which the sanctity of contracts is protected. The legal order must also allow for bankruptcy and orderly workout procedures.

Second, it is in the interests of all parties that negotiations between debtors and creditors be cooperative and orderly, including in the exceptional event that a country's payment difficulties necessitate a debt restructuring. If debts owed to official bilateral creditors are restructured, there will be a presumption that appropriate categories of debt owed to private creditors, including bonds and other marketable securities as well as bank loans, will be restructured on comparable terms if they are material to the debtor's payments capacity.

Third, if a country adopts a strong program of policy reform, financing from the international financial institutions should remain available to a country that has arrears to private creditors on its external sovereign debt, provided that the country is engaged in a good faith effort to negotiate with its creditors.

Fourth, official support for a country experiencing temporary payments difficulties may be critical to catalyzing needed policy reform and restoration of confidence. The actions of private creditors will be critical, but the question of whether specific measures are needed from the private sector is a function of individual circumstances.

No single template applies uniformly in all situations. The flexibility of a case-by-case approach can help us to avoid serious mistakes that could sow the seeds for the next crisis. In this regard, the staff's description of the conditions which made Korea's concerted rollover a success and the reasons why such rollovers may not always be successful, are important. In particular, in cases involving more complex debt structures, concerted bank rollovers could exacerbate crises by inducing a rush for the exits at an earlier stage in other sectors and/or by other creditors. Some of that may have been evident in Brazil. Under these circumstances, the use of moral suasion by supervisory authorities in the lending countries should be reserved for those rare cases when there is a high probability of success and concerns about systemic stability clearly outweigh the legitimate concerns of the regulators about such approaches.

As noted, we agree with staff on the importance of having efficient and effective bankruptcy procedures to facilitate orderly resolution of private sector insolvencies. However, developing and putting in place such insolvency regimes is difficult and time consuming at best as staff have learned most recently in Indonesia. The development and adoption of the UNCITRAL model law could help facilitate the process harmonizing treatment of cross border insolvencies but it will take time to have satisfactory national regimes in place over a wide range of countries.

Similarly, the introduction of collective action clauses in sovereign bonds could facilitate voluntary cooperative solutions although a number of questions must be resolved. The IMF-sponsored seminar next week on the terms and conditions of debt instruments will provide an opportunity to assess experience, better understand the complexities involved, and determine the potential implications for orderly work out. In particular, we need to better understand the reasons why different approaches have been taken and the effects of differences in governing laws, registration arrangements, and regulatory practices. For example, I wonder if staff can tell us if the English trustee deed structure is commonly used for sovereign bonds issued in London. If not, why not?

Consideration also needs to be given to intermediate options between voluntary restructuring and a formal default, particularly the possible modalities for such an option in the form of a credible threat of non-payment. In this regard, the IMF's lending into arrears policy can play a useful role as we move towards the far end of the spectrum, and we look forward to the Board's consideration of specific criteria for implementing the decision to extend the current policy.

Finally, we continue to oppose proposals to impose an internationally sanctioned stay on creditor litigation through an amendment to Article VIII, 2(b). Such an amendment would risk tilting the balance too far in favor of breach of contract and could create serious moral hazard. Experience to date does not indicate that litigation is a sufficiently significant impediment to an orderly resolution of payment crises to warrant such a drastic step. Consequently, I consider the Article VIII issue to be a diversion, particularly given that such an amendment lacks the clear political consensus for adoption and would detract from efforts to develop more practical solutions to reduce the risk of disruptive legal action.

Mr. Harinowo said that he shared Ms. Lissakers's view on the issue of Indonesian bankruptcy procedures. That is why he had suggested that the staff paper should elaborate further on the Jakarta initiative, as that experience had been informative. The results from court-based bankruptcy proceedings had been unsatisfactory, whereas out-of-court proceedings seemed to have been progressing well.

Mr. Hansen noted that the Greenspan proposal, which aimed to discourage short-term lending flows, was problematic from a prudential perspective, as short-term loans were less risky than long-term loans. Even the Basle accord provided incentives to focus on short-term lending.

On the issue of contagion, the Board discussions in autumn 1998 had focused on the so-called process of deleveraging, Mr. Hansen continued. The process mentioned by Ms. Lissakers seemed to be something different. He recalled a statement by the Mexican finance minister that the market did not seem to be working at all, as there was no money available even with premiums of 1500-2000 basis points. That suggested that the events surrounding that crisis were more than a simple shift in market conditions, and so did not involve the type of contagion that had been considered previously by the Board.

Ms. Lissakers commented that Mr. Greenspan had remarked publicly that the Basle provisions, as currently designed, created a pricing bias for short-term interbank lending to OECD countries. He had suggested that those provisions might have helped contribute to the large accumulation of short-term interbank obligations by Korean banks—reinforced by domestic regulations restricting inflows of medium- or long-term capital. That was one more example of an instance of unforseen consequences of regulatory action.

Mr. Kapteijn commented that Mr. Wijnholds's proposal had not been intended as a rigid formula. The underlying philosophy was that the Board seemed to have agreed that the Fund should not meet 100 percent of any financing gap, so that a compromise might be somewhere between 0 and 100 percent. Mr. Wijnholds's proposal was simply an attempt to reach agreement on the appropriate level of external burden sharing.

Mr. Donecker noted Ms. Lissakers that most of the measures discussed would not affect off-balance sheet transactions. That was an important consideration, and deserved further attention.

Ms. Lissakers commented that the proposals under discussion tended to focus on bank claims and bonds. The world was somewhat more complicated, but U.S. regulators and a committee of private bank experts were considering ways to deal with off-balance sheet items and highly leveraged institutions.

Mr. Al-Turki made the following statement:

> I welcome this further discussion of the role of the private sector in forestalling and resolving financial crises. During last week's discussion of the contingent credit line, this Chair emphasized that success in addressing capital account crises will depend in large part on success in involving the private sector. While there are encouraging indications that some degree of involvement has been achieved, this issue remains a difficult challenge. In this connection, I will make a few selected remarks on the issues discussed in the paper.

First, increasing the involvement of the private sector in forestalling and resolving financial crises may well lead to increased borrowing costs. However, if such involvement would reduce the frequency and severity of crises, the increased borrowing costs would be well worth paying. As experience has shown, crises carry heavy overall costs not only for the countries directly involved but to the global economy through contagion and second round effects.

Second, I agree that any strategy for involving the private sector in crisis prevention and resolution carries risks. While staff has to be prudent in assessing those risks, I agree with Mr. Yoshimura and Mr. Ogushi, and others, that it is important not to overestimate such risks. If orderly mechanisms to involve the private sector are not devised and implemented, the private sector will still be involved involuntarily when a crisis hits through unilateral actions by the affected country. The costs of this alternative would be higher for all, including innocent bystanders. Therefore, we need to move ahead in developing a strategy for private sector involvement.

Turning to the specifics, I join staff and other Directors in emphasizing the importance of prevention. First and foremost, borrowing countries should adopt prudent macroeconomic and regulatory policies, including external debt management and strong supervision and prudential regulations to help ensure a sound financial system. Here, prudential measures to regulate the inflow of short-term capital may have a role to play. In addition, the importance of increasing the exchange of information and coordination between debtors and creditors during normal periods cannot be overemphasized. In addition, efforts should be made to encourage the corporate sector to strengthen its balance sheet through increasing equity financing.

On the lender side, it is essential that risk is priced accurately on the premise of no official bailout. In this connection, financial institutions will need to pay more attention to the debt profile of borrowers. Supervisory institutions in lending countries would need to play a more active role in monitoring and containing the short-term exposure of their banking system. In this regard, the Greenspan proposals are worth examining in more detail.

Market-based contingent credit lines are also a mechanism worth exploring. A number of countries have already used this mechanism with some success. It is true that such credit lines may not be available to all countries, and even when available, the cost may be high for some. This is to be expected, however, as lenders would need to be compensated for higher risks. Indeed, the inability of countries to obtain such lines of credit should be an early warning signal of the need to strengthen economic policies.

On modifying bond covenants, it is essential that industrial countries introduce such modifications in order for the bonds to gain market acceptance.

While it is important to continue contacts with the private sector to develop model clauses, it is equally important not to drag this issue for a long time.

In case of substantial pressure on reserves and the exchange rate with significant spillover effect on other countries, litigation stays could be a last resort. Amending Article VIII, Section 2(b) to allow the impositions of a stay on enforcement by creditors is relevant in this regard.

In conclusion, involving the private sector is a complicated matter which may have no perfect solution. However, a combination of the proposals detailed in the paper could go a long way in addressing this issue. In this connection, I agree with staff that improvements on this front should evolve as we gain experience, nevertheless we need to strengthen our efforts as inaction could prove very costly.

With regard to the publication of today's discussion and Summing Up, I fully agree with the remarks of Mr. Donecker and support his request.

Mr. Rouai made the following statement:

Under a market-based economic system, both debtors and creditors need to share the gains, but should also accept losses. We should keep in mind that, in view of the growing interdependence and openness of economies, the next crisis will be unforseen and unavoidable despite the best of intention.

Prevention should remain the first line of defense against crises. This include sound macroeconomic environment, improvement in the dissemination of statistics and information, and the adoption of prudential regulations governing assets and liabilities of the banking system. Capital account liberalization regarding the consolidation of the banking system should proceed with caution and appropriate diligence. Care should be devoted to avoid countries' exposure to short-term external liabilities and other speculative capital flows.

There is a growing recognition that there is a need and a shared benefit in developing mechanisms to involve the private sector in crises prevention and resolution. It is important that these mechanisms reflect a collaborative behavior between debtors and creditors. Unilateral actions should be avoided and market-based mechanisms, such as those developed by Mexico and Argentina, should be encouraged.

Table 1 shows however the mixed progress achieved in improving private sector involvement in forestalling and resolving financial crises. In view of the difficulties associated with implementing the identified measures, I believe that, for the time being, there is a need for the application of moral suasion by the international community on a case-by-case basis and for the involvement of the Fund to promote, among other things, concerted rollovers.

I can support further work in collaboration with other parties to advance the ex ante proposals summarized in para. 51. In particular, I support an early consideration of the Greenspan proposals to reduce the attractiveness of short-term lending. I also support maintaining constructive contact between debtors and creditors and, when necessary, consideration of mechanisms for orderly debt workout between debtors and creditors and with the involvement of the Fund under an amended Article VIII. This will enhance the Fund's catalytic role in involving the private sector in forestalling and resolving financial crises. I am open to Messrs. Yoshimura's and Ogushi's call for the use of official guarantees to enhance new debt in some cases.

Before concluding, I would like to point out that an ad-hoc impact of the current crisis has been the realization by some countries of the benefits by accelerating privatization to compensate for the difficulties associated with raising external financing under appropriate conditions.

Finally, I can support the publication of the staff report and the summing up of today's discussion.

Ms. Patel made the following statement:

The topic under consideration is very opportune, as the involvement of the private sector in preventing and resolving financial crises is a critical complement in the overall effort in maintaining the stability of the international financial system. We commend the staff for preparing the papers on such complex issues in a concise and informative manner and welcome the reorientation of the focus on identifying measures to prevent crises rather than on ex post solutions.

Progress in involving the private sector in crisis resolution has so far been slow and as stated in the paper there are no easy solutions to ensure its full participation. Avoiding the inherent risk of a hasty behavior on the part of the private sector at the first signs of a crisis will remain a major challenge and a difficult task that will not always be successful. This should not, however, deter us from seeking a more meaningful involvement of the private sector in the burden sharing of crises resolution. In this regard, it is important to bear in mind that for many emerging market countries, notwithstanding the prevalent strong economic fundamentals, the massive cross-border capital flows have caused disruptions in domestic financial markets making the implementation of the monetary and financial policies very difficult. In addition if capital flows are relatively high, compared to international reserves, they can also outpace the authorities ability to manage their implications on the balance of payments as well as impact seriously on economic growth, if domestic institutions relying essentially on foreign capital for their activities are forced into liquidation. Therefore, as illustrated in the case of many of the recent crises countries, the involvement of the private sector through moral suasion proved to be fundamental to progress towards financial stability.

The proposals suggested in the staff papers aim, essentially, to influence private sector decisions in the interest of more orderly conditions for the implementation of the adjustment process and strengthened market discipline to improve the efficiency of international capital markets. While these proposals constitute a good start to address some of the problems currently faced in this area, further work seems to be required, particularly, on what motivates private investors to move funds into, and out of, countries; on risk models and risk analysis within private sector institutions in respect of cross-border investments; and on using incentives in influencing international capital flows with a view to creating a more stable environment.

We continue to reiterate that prevention should continue to be the first line of defense against financial crises. During our last discussion we lent our support to the suggested preventive measures, emphasizing, among others, the importance of pursuing sound economic policies, establishing an efficient and well-regulated banking system and maintaining a timely and accurate flow of information to markets to enable the private sector to better assess their lending decisions. We also stressed the need to regulate and improve monitoring especially of short-term capital flows including those to non-banking sector. To these we might add that, a critical element in prevention concerns the assessment of member's vulnerability to shocks and its repercussion on the external position. Given the pace of development in financial systems it is essential to make a close assessment of this element by constant updating analytical frameworks to reflect the latest market practices. Maintaining an appropriate debt structure could be an important tool to prevent the excessive accumulation of short- term external debt and could assist to ensure adequate levels of both official reserves and banking system liquidity at times of reduced access to capital markets. Like other speakers, we see much merit for an early consideration of the Greenspan proposals by the Basle Committee as they would tend to exact greater discipline on cross border interbank market by reducing the current bias towards short-term lending.

The contingent financial arrangements, are seen as offering the potential for encouraging the private sector participation through a marked-based, risk-sharing mechanism. Notwithstanding the attractiveness of such credit lines in terms of providing additional financing in times of crisis to help offset adverse developments in the external accounts the staff candidly recognizes that it might be premature to draw definitive conclusions from the few cases where they have been used. It is also unclear to what extent lenders would be prepared to provide this financing to a broader range of market participants while questions are also raised about their cost effectiveness compared to other financing. Notwithstanding these and other answered questions, South Africa in our constituency, appears to be quite comfortable with these arrangements and have made extensive use of these credit facilities as a second line of defense in times of large capital outflows.

Regarding the foreign sovereign bonds the proposals to introduce sharing clauses, majority decision rules and collective representation provisions do not seem to pose any problems. However, we would have appreciated if more attention would have been accorded to analyzing the problems of secondary trading in sovereign bonds through financial markets. This appears to have been the major conduit through which the contagion effect of the Asian crisis affected the South African economy.

As a last point, we believe that consideration should also be given, in future papers, to aspects like the financing of speculative positions in domestic markets, namely, through arrangements such as stock-lending, uncovered open positions, and straight-forward loans from domestic banks, which would enable us to better understand the intricacies of this complex issue.

The Acting Chairman made the following summing up:

Executive Directors welcomed the opportunity to discuss further the important and complex issues associated with involving the private sector in forestalling and resolving financial crises.

Directors emphasized that recent crises have brought with them extensive economic dislocation, heightening the need for—and the rewards to—much stronger efforts at prevention. Nevertheless, crises will occur, and when they do, or when they threaten, the resulting uncertainty provides country authorities, and the international community more generally, with a difficult balancing of choices. While there are no easy answers, Directors agreed that more needs to be done to create incentives and instruments for the private sector to remain involved. A range of options in this area has been discussed in a number of fora, and some of the more promising options are becoming clearer. Directors agreed that there is no silver bullet to ensure that private creditors will participate fully in the resolution of financial crises, and that improvements in this area are likely to be evolutionary rather than revolutionary. They underscored, however, that neither the inherent complexity of the issues and the potential risks involved, nor the need to acquire additional experience, should hold back progress. Directors therefore broadly agreed that in those areas where consensus can be achieved and progress seems possible, the Fund should now move expeditiously and pragmatically to develop and implement workable options in areas of its purview, and national authorities and other fora should be encouraged to expedite their work on other options to move the process forward.

Looking at the experience of the past 18 months, Directors noted that the private sector has by no means escaped losses in the crisis countries. In some cases, exposures have been maintained, and private creditors have taken substantial losses on longer-term and illiquid claims. Yet, short-term capital flows remain the Achilles' heel of the international monetary system.

Prevention remains the key and is the primary responsibility of individual members working in collaboration with the Fund and the international community more generally. Directors noted that members' efforts should be aimed at improving both their macroeconomic and structural policies, and the environment for private sector risk assessment and decision making by improving the flow of information and the regulatory environment. But prevention needs to be buttressed by measures designed and adapted ex ante to better ensure the involvement of the private sector in crisis avoidance or orderly resolution. In this regard, several Directors observed that, over the medium term, any effect of such measures reflected in higher interest rate spreads could well reflect greater efficiency and improved risk assessment in private capital markets.

Mechanisms are also needed for dealing with extreme situations when ex ante measures do not deliver the needed support and it is not possible to reach agreement on an orderly debt restructuring. In working to foster a system that produces more orderly adjustment, Directors stressed the principle that contracts should be honored. It is important for the efficient operation of markets that proposals to permit the modification of contracts ensure that both lenders and borrowers understand the rules of the system and abide by them and that in extreme circumstances cooperative solutions be sought to countries' financing problems.

Several Directors warned that care is required to ensure that solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could potentially cause more difficulties than they solve. They noted that, for each member, this requires avoiding excessive damage to prospects for the resumption of market access following a crisis. For the international community as a whole, care must be taken to avoid actions in periods of stress that could have adverse systemic effects through contagion to other markets and longer-term effects in impeding international capital flows.

Prevention

Directors noted the importance of countries maintaining an appropriate debt structure, by avoiding the excessive accumulation of short-term or senior external debt, and by ensuring adequate levels of both official reserves and banking system liquidity, to help provide an orderly handling of a temporary reduction in capital market access. In this connection, they were encouraged that a number of countries are establishing systems for the high-frequency monitoring of private external liabilities. These systems can play an important role in allowing countries to better monitor short-term capital flows and provide early warnings of emerging difficulties. Directors urged the staff to continue its work in assisting members in this area.

Directors further underscored the importance of countries exercising appropriate restraint with respect to their own off-balance sheet transactions and taking account of financial entities' vulnerability to financial derivatives. Limiting the use of put options in sovereign debt instruments, and ensuring that appropriate action is taken in the context of supervision of banks' exposure to such instruments, should reduce the likelihood and/or the severity of financial crises. Directors encouraged the staff to give more attention to potential vulnerabilities associated with debt structures and financial derivatives in the context of both surveillance and the use of Fund resources. Transparency in the operations of a variety of financial intermediaries, such as hedge funds and investment banks, is also essential to help limit the size and volatility of short-term capital flows. Some Directors also supported recourse to market-based controls on capital inflows on a temporary, limited basis as a means of addressing the volatility of short-term flows, but cautioned that this should be part of a broader package of appropriate adjustment measures.

Creditor Contacts

Directors highlighted the importance of maintaining effective communication between emerging market borrowers and private capital markets. Most Directors felt that such contacts have thus far proved their worth during periods of market stress in Latin America. In this regard, several Directors suggested that the Fund should seek to assist member countries in establishing regular communication with their creditors, including giving further consideration to the creation of creditor-debtor councils, with due attention to potential problems such as those of insider information. The Fund should also consider expanding its regular contacts with markets.

Proposals Regarding Interbank Credit Lines

Most Directors saw merit in proposals that reduce the perceived bias toward short-term interbank credit lines from industrial countries to emerging market banks. Directors noted that the Basle Committee on Banking Supervision (BCBS) is engaged in a reassessment of the Basle Capital Accord, and is considering on a fast track certain proposals. Those proposals are expected to be addressed in a consultative document scheduled to be made public in April 1999. They encouraged the group to press ahead with its accelerated timetable and to give the earliest possible consideration to the various proposals that have been tabled, with a goal of early implementation of those that can gather international support.

Ex Ante Measures and Extreme Situations

Directors considered a number of specific proposals for involving the private sector. A few Directors considered that a number of these options could be among the criteria used for assessing members' eligibility for any facility in the Fund for the provision of contingent credit lines to member countries.

Private Contingent Credit Lines

Directors considered that there would be merit in the greater use of contingent lines of credit from the private sector that could be drawn on in times of difficulty. Many Directors noted that, if fairly priced, these mechanisms could provide efficient insurance against adverse market developments, including liquidity risk, and could contribute to effective burden sharing during periods of stress. At the same time, Directors recognized that, in complex financial markets, hedging strategies of private financial institutions could affect the additionality in private sector exposure associated with such arrangements. To the extent that banks implement such strategies for managing country and overall emerging market exposure, the activation of particular arrangements in times of crisis could lead to offsetting transactions with the country concerned and/or shift pressures to other markets. Nevertheless, Directors considered that, while care would need to be taken in their design, members should be encouraged to explore contingent credit lines with private financial institutions.

Call Options in Interbank Credit Lines

Directors also revisited the proposal to embed call options in interbank credit lines as a means of providing a contractual basis for an extension of maturities under specified conditions. Some Directors cautioned, however, that interbank credit lines often were a key source of short-term liquidity for countries, and that concerns regarding the triggering of such options could lead to a loss of maturing short-term credit lines in advance of a call, thereby exacerbating liquidity difficulties. But some others felt that these instruments should be given further consideration as they could provide an important safety valve to address the volatility of short-term capital flows.

Debt Service Insurance

Directors saw merit in further study of the feasibility of using debt instruments, including structured notes, that generated a debt service burden that varies counter-cyclically against overall economic developments of the country. A few Directors noted that such instruments are more likely to be feasible for members that have highly concentrated exports (such as many oil or primary commodities exporters), where contracts can be linked mainly to exogenous developments and where there are counterparties willing to share the risks. Here, too, Directors encouraged the members to explore such instruments with their creditors.

Guarantees

Directors noted that a number of recent proposals for involving the private sector entail official enhancements of new debt through full or partial guarantees of new sovereign or private emerging market debt instruments by official creditors, including international financial institutions. Directors took note of the recent experience with such guarantees in encouraging private sector involvement. A few Directors believed that such guarantees held promise at times when market access is very limited, for example during the emergence from a crisis. Some other Directors, however, expressed concern about the effectiveness of guarantees. Directors noted that the World Bank has recently reviewed its experience with guarantees and has proposed a limited guarantee program, and they looked forward to a further assessment of the experience with policy-based guarantees at an appropriate point.

Concerted Rollovers of External Debt

Directors noted that short-term, cross-border interbank credit lines have been a source of particularly acute balance of payments pressures in a number of recent cases. Most Directors agreed that in the case of Korea, against the background of a hemorrhaging of official reserves and the prospect of an imminent default, the concerted rollover of short-term bank lines was successful in stabilizing a critical situation and facilitating a restructuring of interbank claims into sovereign guaranteed bonds. However, some Directors noted that Korea's success reflected some special circumstances, and could be difficult to replicate in other cases. Moreover, the impact of a sovereign guarantee on the restructured instruments could reduce the incentives for creditors to assess and manage risks. Some Directors underscored the danger that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted rollover. Several Directors stressed that concerted rollovers could be effective only when supported by appropriate adjustment policies deemed credible by markets. Directors were encouraged by the recent success of the Brazilian authorities in securing the agreement of international banks to maintain their exposure to Brazilian financial institutions. This agreement promises to provide a steadying hand during a difficult period, and should enable Brazil to secure the necessary financing and return to normal creditor-debtor relations, without either a concerted rollover operation or sovereign guarantees of the rollovers.

Bankruptcy

Directors emphasized the importance of countries pressing ahead with efficient and effective bankruptcy procedures to facilitate orderly resolution of private sector insolvency.

Restructuring International Sovereign Bonds

Directors underscored that the question of whether or not, in the face of a severe liquidity crisis, sovereign bonds should be included in a comprehensive debt restructuring raises difficult issues, which would need to be considered on a case-by-case basis. Generally speaking, Directors saw a trade-off between the immediate cash flow relief associated with bond restructuring and the reduction over the medium term in the member's ability to mobilize resources from private creditors. They noted that, in recent years, there has been limited experience with restructuring sovereign bonds and similar instruments, and so it is difficult to predict how bond restructurings will unfold. Directors supported moving forward with the recommendations regarding the modification of bond contracts to include: sharing clauses; provisions for the modification of terms by qualified majorities; and collective representation provisions. A few Directors noted that British-style Trust Deed bonds contained such clauses and could serve as a useful model for future issues. While consideration was being given to this issue in other fora, little concrete progress had occurred to date; this suggests that some form of concerted action by major industrial countries to encourage emerging market borrowers to modify the terms of their new issues will be required. One approach would be to rely upon a combination of a demonstration effect, through the inclusion of the new contractual terms in international bond issues by G-10 sovereigns, and a coordinated regulatory requirement for new sovereign issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions. A concerted regulatory approach, intended to reflect systemic concerns, would go beyond the traditional role of security market regulators to protect investors. Some Directors also thought the Fund should encourage members to include such terms in bond issues, including in the context of the use of Fund resources. These steps could be complemented by efforts to build a consensus in support of these changes among the financial institutions involved in issuing and underwriting sovereign bonds.

Extreme Situations

With respect to extreme situations, the Fund's policies on lending into arrears to private creditors are being modified so as to permit, on a case-by-case basis and under well-defined conditions, early Fund support for a member's adjustment efforts during a possibly protracted period of good-faith negotiations following the emergence of arrears to private creditors. Certain issues remain to be resolved regarding the conditions under which the Fund would proceed, and Directors will return to this at an early date. But in general, Directors reaffirmed their readiness to consider lending into arrears to private creditors where warranted.

Directors gave further consideration to the possibility that aggressive litigation by dissident creditors could block progress toward orderly restructuring of debt and challenge the Fund's ability to support a member's adjustment efforts. A number of Directors considered that the possibility of amending Article VIII, Section 2(b) so as to allow the Fund to sanction a temporary stay on creditor litigation warranted additional consideration. Other Directors saw little potential danger of creditors resorting to disruptive litigation on any significant scale, and were not persuaded by the need for an amendment or for consideration of other similar approaches. Directors will have an opportunity to return to these issues shortly in the context of an Executive Board workshop on legal issues associated with debt workouts.

Directors noted that the agenda for the future will require the broad support of the international community. In cases where actions fall mainly within the responsibility of the Fund, it will need to proceed expeditiously. Where authority lies elsewhere, the Fund should do what it can to assist in moving deliberations forward. In particular:

In the area of prevention

1. National authorities should intensify their efforts at prevention, including through maintaining an appropriate debt structure, and improving early warning systems.

2. Staff should continue to assist countries in establishing systems for the high frequency monitoring of private external liabilities, and intensify its surveillance over debt structures and financial derivatives.

3. Countries should maintain effective communication with private capital markets. The Fund also should consider expanding its regular contacts with markets.

4. Members are encouraged to support, on a fast track within the BCBS, measures to eliminate the bias in favor of short-term interbank credit lines.

As regards ex ante measures and extreme situations

1. Members should consider establishing contingent credit lines from commercial banks, while taking care in their design to reduce the risks that drawings on such facilities will lead to offsetting transactions in that or other markets.

2. Fund staff will continue its study of various instruments, including call options in interbank credit lines.

3. Members should explore with their creditors the possibility of debt instruments that efficiently and appropriately shift risk (including structured notes).

4. National authorities should move urgently to reach agreement on modification of bond contracts to include: sharing clauses; provisions for the modification of terms by qualified majorities; and collective representation provisions.

5. The Fund will return to its policies on lending into arrears to the private sector shortly. A number of Directors recommended that further consideration be given to whether and how to respond in the event that creditors were to block progress toward orderly restructuring of debt.

Finally, while crises cannot be avoided, with progress in these areas the risk of future crises can be reduced and the dislocations associated with crises alleviated.

2. CAMBODIA—1999 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1999 Article IV consultation with Cambodia (SM/99/47, 2/23/99). They also had before them a statistical annex (SM/99/55, 3/2/99).

Mrs. Hetrakul submitted the following statement:

I wish to convey my authorities' appreciation for the fruitful discussions with the Fund mission for the Article IV Consultation. They would also like to express their deep gratitude for the conduct of the Third Consultative Group Meeting organized by the World Bank and the Government of Japan during February 25–26, 1999, which marked the first international meeting in 18 months in support of Cambodia's reform efforts.

The year 1998 remained a difficult year for Cambodia, with continued deterioration in macroeconomic performance partly as a result of the recession in neighboring countries, and domestic political uncertainty in the run-up to the elections. Now a new coalition government has been firmly established, signifying an end to the prolonged conflict and social strife. The Government has on several occasions reaffirmed its commitment to broad-based structural reforms and fighting deep-rooted corruption with a view to laying a strong foundation for economic recovery and sustainable growth over the medium term. My authorities believe that these reform efforts, supported by financial and technical assistance from the international community, should contribute to a fast return of confidence and quick rebound of the economy in the immediate future.

My authorities broadly concur with the staff appraisal of economic performance in the past year and the 1999 outlook. Real GDP growth in 1998 stagnated with no growth in agricultural output, a contraction in the service sector, and marginal growth in industrial production. The inflation rate peaked at

19 percent in June before tapering off to 12 percent at year-end, driven by increased price of rice and exchange rate depreciation. Fiscal performance remained weak as a result of shortfalls in revenue, higher-than-budgeted military expenditure, and a lack of foreign financing. Reflecting the government's recourse to bank financing of the budget and the economic slowdown, private sector credit declined.

The macroeconomic situation should improve over the course of 1999 as political conditions stabilized towards the end of the year, leading to a more peaceful environment that is conducive to growth and investment. Since the new Government assumed office in November 1998, signs of economic recovery have emerged, the exchange rate has stabilized, and inflation has declined. Output growth for 1999 is targeted at 4 percent, to be driven by the agricultural and tourism sectors, as well as domestic and foreign investment. The garment sector, in particular, has been growing well, and tourism prospects are expected to help improve the services sector significantly. Meanwhile, inflation is expected to fall to 6-7 percent, aided by an expected good agricultural harvest and tightening of central bank credit to the government.

At this critical juncture, monetary and fiscal policies will be implemented with prudence with a view to supporting economic recovery, lowering inflation, and promoting a stable exchange rate. To achieve financial stability, the monetary authorities are committed to eliminating central bank net lending to the government, and making efforts to reduce the degree of dollarization without recourse to administrative measures by ensuring sound macroeconomic policy and strengthening the banking sector. Meanwhile, the flexible exchange rate regime that has served the country well will be maintained; the official exchange rate will be adjusted on a daily basis in order to keep the spread with the parallel market rate within 1 percent. Since there are no restrictions on payments and transfers for current transactions, acceptance of the obligations of Article VIII, Sections 2, 3, and 4, of the Fund Articles of Agreement is kept under active review.

Recognizing slippages of structural policies in the past two years, the Government is strongly determined to put back on track policy measures that are preconditions for the resumption of negotiations on a possible new ESAF arrangement. Several measures have already been introduced. In the fiscal area, improvement of fiscal management remains at the center of government effort to achieve fiscal sustainability over the medium term. Aimed at domestic revenue enhancing, these measures include a significant increase in the collection of timber royalties as required in the 1999 Budget Law, elimination of all ad hoc exemptions for tax and import duty as well as the export tax exemption for rubber and timber, and imposition of a value-added tax starting the beginning of this year. These measures will not only help improve fiscal governance, but also maximize government revenue.

On the expenditure side, the strategy is to reorient current expenditure from defense and security to basic health and education, as recommended by the World Bank, while conditioning capital spending on the availability of foreign financing. Meanwhile, the Government will attempt to streamline and improve efficiency of the civil service, through downsizing the civil service and improving the pay scale. Other efforts include the prevention of leakages, the reduction of scope for corruption, and the enhancement of transparency and accountability in every sphere of government activity.

As regards forestry management, the Prime Minister has taken personal interest in this particular matter. Following the increase in illegal logging and log exports in 1997-98, efforts have been stepped up to fight illegal activities and corruption as stipulated in the January 22 Declaration. The Declaration sets out clearly the responsibilities of relevant authorities in forestry management, including monitoring the purchase, sale, and transportation of illegally cut logs, thus reducing the possibility of corruption in the forestry sector. It also spells out disciplinary sanctions against those involved in illegal activities and reinforces the ban on exports of logs and sawn timber. No new concession has been granted since October last year and all existing contracts will be reviewed; those found to be in violation of the contract or the law will be canceled. Twelve concessions have so far been canceled. For greater transparency, a summary of concession contracts has also been released for public scrutiny.

In addition, a new comprehensive forestry legislation is being prepared for parliamentary approval. An independent unit is to be set up urgently to monitor logging, log processing, and log exports in accordance with the provision of the January Declaration, with the help of international technical experts.

In the banking sector, much progress has been made to modernize the banking system and at the same time strengthen bank supervision with a view to increasing public confidence. Priority now is to be placed on the quality rather than the quantity of banks. In this respect, the Commercial Banking Law, which is currently under consideration by the National Assembly, will empower the National Bank of Cambodia to close any bank operating in violation of the law. The authorities recognize the need to adopt this law at the earliest date possible. Technical assistance has also been actively sought to enhance the central bank's supervisory capacity, and improve the legal framework and accounting standards.

Privatization of major state-owned enterprises has proceeded satisfactorily and will continue in 1999 within the context of the Law on Public Enterprises. It is somewhat more difficult and time-consuming to divest medium- and small-sized SOEs, however, until the issue of severance payment can be settled.

My authorities fully recognize the many challenges that lie ahead. With a more politically peaceful climate, the Government is now in a better position to concentrate on economic and structural issues. The most important agenda, as announced by the Prime Minister, is speedy poverty alleviation and economic progress. The Prime Minister has indicated his strong determination to accelerate key structural reforms, improve public governance, and rebuild international confidence in the Cambodian economic and political systems.

Lastly, I wish to again convey my authorities' true appreciation for the tireless efforts and dedication of the Fund mission to help Cambodia reaccess technical and financial assistance from the international community. Above all, they are deeply grateful to those participating in the Third Consultative Group Meeting, and hopeful to receive favorable consideration as regards the request for a new ESAF-supported program.

Extending her remarks, Mrs. Hetrakul noted that because of the more peaceful political climate, the authorities were in a better position to concentrate on economic reforms and were ready to proceed expeditiously with the reform package.

Mr. Lushin and Mr. Zakharchenkov submitted the following statement:

In the period following the completion of the 1998 Article IV Consultation the developments in the Cambodian economy were hardly encouraging. Economic growth stagnated and inflation picked up while a continued weak fiscal performance eventually led to the reopening of central bank credit to the government. In addition, there was little progress in the implementation of structural reforms. However, by the end of the year some signs of economic stabilization had emerged following the formation of the coalition government. Hopefully, the strict adherence to economic prudence, which has been declared by the government officials, will eventually form the basis for bringing the Cambodian economy back onto a sustainable path. We broadly share the policy recommendations presented in the staff report. This said, we would like to highlight several important issues.

The authorities should pay close attention to the continued weak fiscal performance, particularly in light of the uncertainties that surround the fiscal projections for this year, and which leave ample room for potential slippages in this area. As rightly noted by the staff, the 1999 budget represents only an initial step towards medium-term fiscal sustainability, and there is a need for much further improvement in the period ahead. Among the top priorities should be measures to reorient current expenditure away from the military area and toward health and education, and measures to strengthen governance in fiscal management. The latter is particularly important in light of the extensive granting of tax and duty exemptions practiced last year. Hopefully, the authorities' strong commitment to fiscal prudence will be accompanied by comprehensive initiatives to address these issues.

The flexible exchange rate regime has served the authorities reasonably well in the past, and we agree with the staff that at this time it would not be appropriate to transfer to a fixed exchange rate regime. However, we remain somewhat skeptical about the possibility to substantially reduce the degree of dollarization of the economy over the medium term, even if sound policies are pursued. On the basis of footnote 8 (page 10) and Table 16 of the Statistical Appendix, one can estimate the share of foreign currency assets in broad money supply (which includes cash dollar holdings) to be not less than 80 percent, with practically non existent bank deposits in riels. Under such circumstances, the most viable medium term policy option seems to be a transition to a dollar-based monetary system or a Currency Board Arrangement (CBA). We note that a CBA for Cambodia was extensively discussed on the occasion of the previous Article IV Consultation (Box 3 of SM/98/80). We would like to hear the staff's current view on this matter in greater detail, and, specifically, under what circumstances a shift to a CBA is possible and/or desirable in the future.

Accumulation of external arrears is a source of concern. We fully share the staff's view that regularization of external payments should be a necessary precursor to a new ESAF arrangement. We, therefore, urge the Cambodian authorities not to delay the beginning of negotiations on debt restructuring with the Russian Federation, in particular, on regularization of sizeable post cut-off date arrears. Here, we would like to reiterate our position that resolving the remaining debt issues with the Russian Federation can only be guided by the framework of Russia's participation in the Paris Club. In this regard, we have reservations about the medium-term baseline scenario (Appendix II), since its assumptions concerning the rescheduling of Cambodia's debt to Russia are different from the position of the Russian authorities.

We fully endorse the agenda of structural reforms for the period ahead and hope that the declared measures will be implemented at an accelerated pace and without delay. Also, we hope that the authorities will progress further in addressing the deficiencies in their statistical system.

With these remarks we wish the Cambodian authorities well.

The staff representative from the Asia and Pacific Department [Otani] noted that during the meeting of the Consultative Group on Cambodia in Tokyo in February 1999, donors supported the authorities' recent efforts to restart fiscal reform and combat illegal logging and corruption. At the same time, many donors were concerned about the authorities' commitment to the implementation of reforms. According to the Prime Minister, the authorities and the donor community in Phnom Penh would meet on a quarterly basis to review progress. The first meeting was expected to take place in May 1999. The donor community had pledged nearly $470 million, which was higher than the authorities' expectation of $450 million. The pledged amount excluded possible balance of payments support from the Fund or the World Bank.

Mr. Ogushi made the following statement:

It is encouraging that signs of recovery in the Cambodian economy are reported following the establishment of a new government. I share the staff's view that the most important objective for the authorities to achieve in 1999 is to build confidence in its economic management. In order for this to happen, it is essential for the authorities to show their strong intention toward economic reform by implementing without delay the policy agenda that they committed to in consultation with the staff. In this regard, it is encouraging that the authorities have addressed most of the concerns raised during the 1998 Article IV consultation as obstacles to ESAF negotiations. However, I regret that significant progress was not seen on some important issues, such as strengthening the fiscal position and forestry management. If there is to be satisfactory progress made on these important issues, this chair strongly supports starting the ESAF negotiations immediately. Now, let me comment on some issues.

On fiscal policy, strengthening the revenue side is a top priority. I hope that the shortfall in non-tax revenue mainly caused by the governance problem will not occur again in 1999. Needless to say, the authorities must address decisively the governance problem. In addition, it is important to achieve the objective of an increase of 1 percent of GDP in non-tax revenue by increasing timber royalties. Regarding the effectiveness of the VAT that was introduced in January, we need to recognize that the administrative capacity of the authorities is a crucial issue. In this sense, I share the authorities' view that they need to strengthen the tax administration. Although I understand that there will be some delay in making the VAT fully operational, I believe that the authorities will be able to achieve their objective of increasing tax revenue in 1999 by 0.75 percent of GDP if they fully utilize their current administrative capacity. On the expenditure side, I regret that there was military overspending in 1998. In this regard, I concur with the staff that the authorities should maintain their tight rein on spending.

Regarding monetary policy, the authorities should prevent huge central bank credits to the government from occurring in 1999 and thereafter. In this sense, it is encouraging that the authorities have enacted a de facto freeze of central bank credit. As indicated by the staff, it is appropriate that the authorities consider the re-establishment of financial stability by strengthening the fiscal position and increasing the soundness of the banking sector as the primary objective of monetary policy.

Whether the authorities can gain the confidence of international society depends critically on their performance in structural reform. On the structural reform agenda, a particularly important issue is to tackle the problem of illegal logging. In this regard, I welcome that the Prime Minister himself expressed his commitment to tackling this issue, and it is encouraging that the authorities have committed to revising the Forestry Law, establishing a monitoring system, and revising the existing concession contracts. The actual steps to be taken on this reform agenda are quite important.

Regarding civil service reform, I highly appreciate that the authorities have committed to accelerate their pace in 1999. The importance of this reform is apparent because it contributes to reducing the corruption and to improving the fiscal position.

With these remarks, I hope that the authorities will actually promote the committed reforms and, as a result, that the ESAF negotiations will begin in the near future.

Mrs. Zador made the following statement:

In 1998 Cambodia suffered with persistent political uncertainty and the aftereffects of the Asian financial crisis, the latter despite the fact that its currency is not convertible and its links to other countries are weak. Since Cambodia's economic partners and main investors were deeply involved in the first wave of the financial problems, contagion was inevitable. The sharp reduction of foreign trade and investment inflows significantly slowed the rate of economic growth in 1998. Another unfortunate consequence of the crisis is that Cambodia's heavy use of the dollar in the economy kept its exports from benefitting from the significant downward adjustment of the exchange rate while the economy felt the full force of faster inflation. Although some signs of recovery appeared at end of the year, business confidence was still subdued, and investments and tourism were at a standstill.

Indeed, Cambodia is now at a critical crossroads. The new government is trying to get the consolidation of the economy under way. This is an enormous task and we hope the government's commitment and administrative capacity are equal to it. The staff rightly points out that much remains to be done to regain investor confidence and to renew access to external assistance. Increased accountability and transparency, anti-corruption measures, greater respect for human rights, and strong adherence to the rule of law are all essential for sustainable development and will affect the level of future assistance.

For all these reasons, we cannot consider a request for a new ESAF arrangement unless we see empirical evidence of real progress with the reform process. Sufficient time should be allowed to permit testing the strength of the government's commitment to build a political consensus for the needed reforms. Especially important is progress with key areas such as fiscal reform, military demobilization, forestry management, and poverty alleviation. In this connection I welcome the refined and updated list of measures that must precede discussions on a possible ESAF-supported program, although I think additional measures will have to be added to this list, such as enhancing transparency and improving governance. I can see two additional areas:

The smooth reintegration of discharged military personnel into civil society is very important for future stability, and must be carefully prepared. The Board should have information about special measures to this end, which would make sure that all available resources, including future Fund resources, can be mobilized in a transparent manner. Like the identification and elimination of the so-called "ghost workers" in the civil sector, the process should be extended to cover military personnel as well.

A second is the publication of Cambodia's fiscal data, either in IFS or GFS pages. This should be a minimum requirement for program discussions to begin. As a further precondition, I suggest the regular provision to the Fund of data on the external current account, including data on flows and disbursements of foreign official assistance. I think the reopening of the Resident Representative Office in Phnom Penh could help a lot in improving Cambodia's data provision and disclosure.

Mr. Cho made the following statement:

We welcome the authorities' recent move toward political stability and economic reform. The consultative group meeting in Tokyo welcomed the authorities' reform efforts, which will contribute to Cambodia's long awaited admission to the Association of South East Asian Nations (ASEAN). This type of international support will certainly serve as a greater impetus for the authorities to increase the pace of reform. With such momentum, we hope the authorities will implement the necessary preconditions to assume a new ESAF-supported program in the near future.

According to the current World Economic Outlook (WEO), the four ASEAN countries' growth reveals a 1.4 percent contraction in 1999, compared to the staff estimate of 4 percent. This seems somewhat optimistic considering Cambodia's agriculturally oriented economic structure and ASEAN-oriented trade relationship, particularly since the authorities have little leverage in stimulating the economy, hindered by a huge fiscal deficit and inflationary pressures.

I agree that the fiscal area should be the centerpoint of the reform agenda, and that an increase in revenues is essential. According to the staff, revenue will increase from 10 percent of GDP to 15 percent of GDP in 2004. In order to obtain such ambitious and sizable revenue gains, I think special measures will be necessary, in addition to full implementation of the value-added tax, and a reduction of tax exemptions. We need clarification from the staff on this matter.

We agree with the staff assessment that priority be given to education and health over defense and security sectors, and encourage the authorities to establish quantitative budget targets for spending more resources on these two important areas.

I agree that there should be an end to monetizing the budget deficit. I support the authorities' intention to reduce the deficit by achieving policy credibility, and through effective financial sector reforms. As the staff suggested, adopting a dollar-based monetary system or currency board may be a viable option to secure market confidence. However, it is important to consider the authorities' administrative capabilities and other necessary conditions before exercising such an option.

There have been various reforms of the budget, civil service, military, and privatization. Considering the limited administrative capacity available to facilitate multifaceted reform, it is important that the authorities plan and supervise the whole reform process with full political support, in an organized way. We support the authorities' pledge to adopt the long awaited commercial bank law, which, if modelled according to international best practices, will foster development of the banking industry.

The number of commercial banks is excessive, given the size of the economy. Closing some banks may be inevitable, and several lessons may be learned from the experiences of crisis countries. In order to minimize serious political and economic repercussions, banks should be closed early on, in a decisive way, using transparent criteria.

A large component of the deficit relies on foreign transfers, which is a trend that is likely to continue, according to the staff's medium-term estimate. The authorities should give more priority to fostering foreign direct investment by improving the business environment and alleviating this reliance.

Mr. Watal made the following statement:

Mrs. Hetrakul's useful preliminary statement indicates that Cambodia is coming out of an era of political uncertainty. This augurs well for Cambodia because in the past the country has so often slipped into political turmoil that whatever economic gains that could be achieved have only been frittered away quickly. Staff in their concise and clear report have mentioned that the prime minister has called for fiscal reform, reducing the level of expenditure on defense and for taking strong action against economic mismanagement. Cambodia's economic future both in the short run as well as the medium term is still vulnerable and fragile therefore the authorities are advised to adhere to their commitments especially if they plan to negotiate a new ESAF.

The macroeconomic indicators as well as the structural reform efforts have not shown any significant improvement in the year 1998. The growth level remained flat and the inflation rate which did come down has remained at a double digit level which is not good for the economy. The fiscal performance was poor both on the side of revenue as well as the profile of government expenditure. Government had to resort to borrowing from the central bank. Given the nature of the Cambodian economy it can be said that the Asian Financial Crisis may have only indirectly helped the economy on account of its heavy dollarization and also the strong performance of garment exports which showed up in a slightly improved trade balance.

We are in agreement with the broad macroeconomic framework that has been suggested in the staff report for the year 1999 including the steps that have been suggested to achieve some of the policy objectives. The Cambodian authorities have demonstrated earlier, despite a failed ESAF, that they have the capacity and capability to stabilize the economy and maintain economic growth. The list of items shown in box one shows the strong commitment of the authorities. Mrs. Hetrakul's remarks are indeed reassuring that the nation is firmly committed to the goal of improving economic performance step by step.

Having said this I will emphasize only a few points which have also been echoed by previous speakers.

There seems to be greater symmetry in the approach to the way both staff and the authorities plan to manage fiscal policy in 1999. It is clear that the performance in the fiscal area will really be of utmost importance if in Cambodia's economic recovery. We would advise the authorities to provide a stronger tax administration. The projected increase of 1.75 percentage points in tax revenue should not be difficult to achieve provided there is no laxity on part of the authorities in giving exemptions and keeping the timber royalties flowing without leakages. We would advise the authorities to be very vigilant in this area. Cambodia has a satisfactory tax administration structure which should respond provided it is given the right direction. The authorities must concentrate on revenue collection measures because a better resource position would also ease expenditure management. It is with some concern that we note that the outlays on education and health will not be increased to the extent that the military expenditures are going to be reduced. This is because the authorities anticipate other current expenditures that may actually have to be made during the course of the year. This in our view could give rise to risks to fiscal management. This aspect could perhaps be addressed by the authorities.

We welcome the measures that the authorities envisage to dedollarize the economy but I would also associate myself with the observations made by Mr. Lushin regarding the need to examine the possibility of a currency board or a dollar based monetary system and would welcome staff's views. We fully support the objective to and improve the effectiveness of the monetary control especially the plan to improve the banking system. Steps will have to be taken without delay to strengthen the supervision and regulation of commercial banks. The immediate objective of establishing financial stability is equally laudable i.e by freezing central bank net credit to government. This will help to bring down inflation to a sustainable level.

The progress on the structural reforms front needs a new push on many fronts. We welcome the formation of the Superior Council for State Reform which is going to oversee and coordinate reforms in public finance, administration, judiciary and the security forces. We hope to see how it has performed in our future consultation exercise. We were disturbed to note that the Rural Development Bank had resorted to direct financing but now this activity will be supervised by the NBC.

Forestry management has been coming up in successive reviews. Administration of the Forestry sector continues to be a problem even though there have been strong statements that this public resource will be managed better . We are happy to note again that the government has taken measures which go beyond what was done last year and effective steps have been taken to fight illegal logging and provide better forestry management and reaffirmed its intention to put in place an effective monitoring system. We would advise the government to give this issue top priority as it also has far reaching environmental fall outs.

We would also advise the authorities to urgently negotiate external payments issues with key bilateral partners and we would encourage that the authorities continue to engage with the fund staff so that a meeting ground is found for a new ESAF.

Mr. Chairman, in conclusion, we would wish to urge that the authorities to focus on these critical areas. With these observations we commend once again the significant efforts of the authorities and wish them success in all their future endeavors.

Mr. Ioannou made the following statement:

I agree with the thrust of the staff's report and recommendations. The key to a recovery of Cambodia's economy is a restoration of confidence, which can be achieved with a return to political stability and a resumption of structural reforms.

Although the efforts of the newly elected government in the area of structural reforms are noted and welcomed, I agree with the staff that a resumption of discussions on a possible new ESAF arrangement requires further efforts on behalf of the government so as to restore credibility, following slippages in the past few years, and prove its commitment to announced structural reforms. I believe the staff must play a more active role in their discussions with authorities, ensuring not only the passage of certain measures but also their workability and implementation. A point in case is the VAT, where legislation was enacted in 1997 but the VAT regime has yet to prove operational. It may also be relevant in light of the current deliberations involving the establishment of a monitoring unit which will ensure conformance to adopted logging restrictions. Staff comments in this regard are welcomed.

In the area of public finances, a tight fiscal policy stance must be adopted to ensure the implementation of the budget as planned. Furthermore, a re-orientation of expenditure from military to education and health is necessary to alleviate poverty, especially in light of the recent adoption of revenue-enhancing measures.

In the banking sector, the authorities must proceed with the establishment of a clear legal framework and step up supervisory capacity, including the strengthening of accounting standards.

Finally, I encourage the authorities to proceed with bilateral negotiations with creditor nations, as called for under the 1995 Paris Club agreement.

Ms. Perez made the following statement:

Cambodia's economy has been one of the causalities of the political conflict between Prime Minister Hun Sen and Prince Ranariddh that first burst into the open in 1996. The timing of events exacerbated the situation, as the collapse of the ruling coalition coincided with the start of the Asian economic crisis. As a result, foreign direct investment dried up immediately, and tourists began to avoid the country out of fear for their personal safety. A final blow to the Cambodian economy came with the suspension of development aid by several major donors, which had previously provided some 40 percent of the budget.

Democratic elections and the establishment of a new coalition government in November 1998 have restored some degree of order and calm. But the task ahead of the new administration is daunting. To escape a vicious cycle of poverty and violence, great efforts have to be directed to the modernization of the economy. A strict adherence to the rule of law and a determined fight against corruption are essential for the sustainable economic development of Cambodia. We encourage the authorities to work assiduously towards rural development to set the basis for a strong, export-oriented agricultural sector. Environmental concerns should be taken seriously, and we demand an end to the illegal logging of Cambodia's precious tropical rainforest. A further hemorrhaging of Cambodia's natural resources will undermine the country's economic success even in the best of political circumstances. We encourage authorities to reduce the share of financial resources going to non-productive sectors, and to shift spending toward health, education and agricultural infrastructure. A continuous improvement in these areas and the strengthening of the country's institutional capacity will call for strong financial support from the international community. The announced commitment of Hun Sen government to fully implement reforms represents a welcome first step towards creating conditions for the return of tourists and foreign investors and for a resumption of aid by those bilateral and multilateral donors which suspended it after the coup.

In the area of structural reforms, we would like to urge the authorities to persevere in their efforts to privatize state-owned monopolies, since progress in this area is vital for improving the infrastructure in Cambodia. A sound banking system and efficient banking supervision will encourage financial deepening and private sector investment.

We are concerned about the low level of domestic revenue, at a time when the government is confronted with great demands on increasing expenditure. An outdated tax system and weak revenue collection risks the danger of becoming a bottleneck in Cambodia's recovery. The introduction of a 10 percent value-added tax (VAT) in January 1999 is an important step to reduce the almost complete dependence of the government on customs revenues, as was the decision to increase taxes on imported cigarettes and alcohol. We urge authorities to intensify measures to eliminating ad hoc exemptions and strengthening tax administration.

We commend Cambodia's authorities recent efforts to correct deficiencies in the area of statistics and encourage them to complete their undertakings. As the timeliness and quality of official data improves, the authorities themselves will benefit from deeper and more meaningful macroeconomic discussions.

Finally, we encourage the Cambodian authorities to maintain their momentum of reforms, and create conscience among the citizens regarding the need for a foundation for a sustainable adjustment and structural reform process attending that progress on governance issues will continue to influence the level of future technical and financial assistance.

We wish the Cambodian authorities every success in their future endeavors.

Mr. Melese-d'Hospital made the following statement:

I would like to thank staff for their hard work under what I understand were difficult circumstances, and for a paper which in my opinion strikes just the right balance between caution in light of the past and optimism for the future. As all my key points have been raised by other speakers, notably Mrs. Zador, I will limit myself to a few points which I believe deserve emphasis.

Certainly, the new government is to be praised both for its ambitious reform agenda and for a number of positive steps taken in its first four months in office. The strategic goals laid out in the government's agenda, including strengthening democracy and the rule of law, demobilization of the military, economic development and poverty alleviation, are all highly appropriate. Reform measures taken to date, including inter alia the closure of illegal logging concessions (15 by our count), registration of the largest opposition-affiliated trade union (after a delay of more than a year), and an agreement to a bilateral textile agreement with the United States which includes an innovative provision to monitor labor conditions in Cambodian factories, constitute a credible down-payment on the reform agenda.

Having said all this, four months is still a very short track-record, there remains much to be done, and actions will, as always, speak much louder than words in the months to come. Cambodia will need the best efforts of its government and its people, as well as substantial donor and creditor support and a portion of luck if it is to begin to achieve its economic potential. On the size of the potential rewards of success, the "good" baseline scenario produced by staff which projects growth of 7 percent in the context of low inflation is illustrative.

In this light, I continue to think the most promising strategy for the authorities will be to focus their efforts in areas with special significance for future cooperation with the IFIs, creditors, and current and prospective bilateral donors. Viewed from this perspective, further progress in areas of resource management, anti-corruption, human rights including notably labor and political rights, civil service reform, demobilization, and redirection of discretionary non-development expenditures (such as military expenditure) towards development goals will all take on even greater importance.

Finally, I would like to second Mrs. Zador's call for further progress in areas of demobilization and provision of data prior to agreement of a new ESAF.

Mr. Kpetigo made the following statement:

Since most of my concerns have been raised by the staff and previous speakers, I will be brief. There is not doubt that Cambodia faced last year a difficult economic situation with a rise of Central Bank financing of the Government, due to large shortfalls in revenue and a sharp increase in military budget and a drying up of foreign financial assistance. However, some progress has been made in structural area, and governance in budgetary management.

We are pleased to note the commitment of the new Government for a radical change in economic management. In this respect, and provided that the recession in neighboring countries diminishes, economic prospects for 1999 are encouraging with much chance for macroeconomic indicators to improve significantly. We encourage the authorities to sustain their efforts to pave the way for a new ESAF-supported program. To this end we welcome the recent international meeting held in Tokyo in support of Cambodia. Indeed, as Mrs. Hetrakul puts it rightly in her very helpful buff statement, " the financial and technical assistance from the international community should contribute to a fast return of confidence and quick rebound of the economy in the immediate future." I therefore encourage the donors' community to provide timely assistance to the authorities.

Finally, like Mrs. Zador and Ms. Perez, I urge the authorities to press ahead with further improving their statistical data. With these remarks, I wish the Cambodian authorities every success in their endeavors.

Ms. Pinzani made the following statement:

A peaceful domestic and political situation is integral to the success of economic developments. We welcome the new coalition government, and hope that future developments will mean increased cohesion within the administration. Indeed, cohesion and political commitment are essential to enhancing fiscal administration, to fighting corruption in managing natural resources, and to making lasting progress in civil service and military reforms.

We fully support the staff's recommendations and urge the authorities to take advantage of the new climate which has inspired confidence in the country. Positive results from the consultative group meeting and the forthcoming admission of Cambodia to the ASEAN should provide incentives to implement policies, particularly in the area of revised spending.

Ms. Lu Ang made the following statement:

This chair would like to commend the staff for providing us with a well-written report. While I concur with the thrust of the staff appraisal, I would like to highlight the following points for emphasis.

First, political commitments and a favorable environment are essential to the successful implementation of the program in Cambodia. As staff pointed out, due to the political uncertainty and the Asian crisis, the macroeconomic performance had deteriorated during most of 1998. However, at the end of the year, especially with the formation of the new government, some signs of economic recovery emerged, the exchange rate stabilized, and inflation declined. The importance of maintaining a peaceful environment for Cambodia economic development has therefore been proved. Rebuilding public confidence in the economy should be the primary target for the new government. Staff has presented an attractive baseline scenario, which was preconditioned by implementing the announced reform agenda, maintaining cautious monetary and fiscal policies, stabilizing the exchange rate, curbing inflation, and attaining a sustained economic growth. Political commitments to the program should play a critical role in implementation of the program. We welcome the new government's determination and efforts in stabilization of the economy, and encourage them to continue to provide support whenever necessary.

Second, on the fiscal policy, efforts should be placed on both the revenue and expenditure sides. As to expenditure management, the authorities should make further efforts to increase spending in health and education. With regard to the revenue, improvement of tax administration should be the top priority.

Third, on structural reform, we appreciate the government's determination to fight against illegal logging. We also support the staff's proposal to urge the authorities to take additional steps to halt the environment degradation, which is very important for the country's long-term development. On financial sector reform, there seems to be an urgent need in Cambodia for a clear legal framework. In this context, we would like to concur with the staff, and join other Directors in urging the authorities to enact the Commercial Bank Law as soon as possible. The development and strengthening of the financial supervisory capacity seems also critical in Cambodia. Technical assistance from the Fund is welcomed. Early adoption of international accounting standards is also encouraged.

On the monetary and exchange rate policy, we support the authorities to continue its current exchange system, without sound banking and legal system as well as efficient macroeconomic framework, the currency board arrangements seem to be premature.

With the above remarks, I wish the authorities further success in the future.

The staff representative from the Asia and Pacific Department noted that the staff's expected recovery in output growth was attributable to several factors. First, because economic activity had been rather depressed largely owing to abnormal weather conditions and a drought that had adversely affected agricultural production, a quick recovery was expected when more normal conditions returned. Second, because the political situation was stabilized and security enhanced, tourism had begun to recover, and it was hoped that this would also contribute to growth. Third, important manufactured exports, like garments and textiles, were expected to be strong, given the fact that export markets in the United States and Europe were performing well. Overall, he was optimistic that further growth could be achieved.

With respect to illegal logging, the staff and the authorities had decided that a monitoring system needed to be established as soon as possible, and competent people needed to be hired to monitor illegal activity, the staff representative stated. A report by a non-governmental organization (NGO) called Global Witness, monitored illegal logging and reported illegal activity electronically around the world. In spite of that, a formal monitoring unit needed to be established. According to NGO and World Bank experts on forestry management, it was important to rely on a few expatriates to manage local natives who moved through various districts observing the activity. According to the authorities, financial support from the international community was essential.

The authorities were determined to establish confidence in economic management through fiscal policy and monetary policy, the staff representative noted. Monetary policy was considered to be closely linked with fiscal policy, in that effective fiscal policy was required for a prudent monetary position. Otherwise, the option would be to resort to other sources of financing. It was crucial that bank financing, in particular, not occur.

The viability of a currency board depended on fiscal sustainability in addition to a strong banking system, the staff representative noted. The banking sector was not yet strong. Unless fiscal sustainability and a sound banking system were established, it was considered premature to move onto a currency board arrangement, for the authorities' ability to maintain the currency board would be subject to skepticism.

The staff representative from the Monetary and Exchange Affairs Department noted that it was possible to increase revenue from the current level of about 10½ percent of GDP, to 15 percent of GDP in three to four years, if there were better tax administration, better governance, and a more efficient tax system. Better collection of nontax revenues was necessary; for example, several line ministries did not transfer their revenues to the treasury. Better collection of timber royalties, perhaps combined with an increase in timber royalties, was another necessary measure. The base for value-added tax collection would expand over time, as would the base for the profits and income tax, which were two areas of additional revenue. Revision of the law on investment was also necessary, for as it stood, the law was extremely generous by international standards, providing long tax holidays, permanent low corporate tax rates, and free imports of investment goods and raw materials. The staff would insist on changing the law on investment, because it was considered a key area for generating additional revenue.

Mrs. Hetrakul thanked the Directors for their invaluable advice and useful comments. With the return of political stability, the authorities were giving first priority to strengthening and accelerating reform efforts on all fronts. They had reaffirmed their determination to carry through the necessary measures in the most expedient manner. Nevertheless, it would be difficult to proceed without technical and financial support from the international community. The authorities were hoping to receive favorable consideration for a new ESAF-supported program in the near future. Financial assistance would not only help support the difficult challenge, but would also mean that the Fund supported the policy framework being pursued.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They expressed disappointment that, in 1998, economic growth halted, the riel depreciated, inflation increased considerably, and there was little tangible progress in addressing key structural reforms. Of particular concern was the continued poor fiscal performance, characterized by extensive ad hoc tax exemptions,

overspending on the military budget, and sizeable central bank financing of the government.

Against this background, Directors welcomed the authorities' recently announced commitment to break away from the past record of poor governance and weak economic policies and performance. They urged the authorities to fully carry out this commitment. Directors emphasized in particular that it was critical to increase transparency and accountability, adhere to the rule of law, take decisive actions against corruption and illegal logging, and improve fiscal management. Firm implementation of these reforms, together with prudent macroeconomic policies, would help lay the foundation for sustainable growth over the medium term.

Directors urged the authorities to address decisively the problem of illegal logging. The recent prohibition against illegal logging activity and exports needs to be enforced vigorously and consistently throughout the country.

Directors welcomed the 1999 budget as a step toward improving fiscal management and achieving a sustainable fiscal position over the medium term. They saw the introduction of the value-added tax as an important step in strengthening revenue performance, and encouraged the authorities to follow through on implementation of the value-added tax, and to improve budgetary governance by strictly maintaining the prohibition on ad hoc import duty and tax exemptions, and by fully collecting revenues from line ministries. Moreover, it will be crucial to revise existing contracts for forest concessions to provide increased timber royalties. Directors encouraged the authorities to shift spending away from defense and security toward health, education, and civilian operations and maintenance, in line with the recommendations made by the recent Public Expenditure Review undertaken by the World Bank. Directors stressed that vigorous pursuit of civil service reform and demobilization of defense and security forces would support the needed reorientation of government spending.

On monetary policy, Directors indicated that the authorities should maintain a freeze on central bank credit to the government in order to provide adequate credit to the private sector. They urged the authorities to pursue macroeconomic stability as the best means to promote increased acceptance of the local currency and confidence in the domestic banking system.

Directors noted that the flexible exchange rate regime has served the Cambodian economy well despite political uncertainties. They supported the authorities' objective of reducing the spread between the official and parallel market rates. Directors also encouraged the authorities to speed up the conclusion of the remaining bilateral agreements as envisaged under the Paris Club accord, and to avoid any further accumulation of external payment arrears.

Directors emphasized the need to address the serious deficiencies in the financial sector. They urged the authorities to pursue the early adoption and implementation of the Commercial Bank Law as an important component of rationalizing the banking system, and to further strengthen supervisory capacity, while continuing on-site inspections of banks by internationally recognized firms.

Directors urged the authorities to improve the macroeconomic database and disseminate economic statistics on a regular and timely basis.

Directors considered that, with improved political stability, the current situation offers a unique opportunity to accelerate the pace at which the authorities can address the key problems in the economy and governance. They expressed the hope that the meaningful reform measures that have already been announced will be implemented consistently, fully, and in a sustained manner, which would help form the basis for a new ESAF-supported program in the future, and which would help mobilize donor support.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/99/27 (3/15/99) and EBM/99/28 (3/17/99).

3. PORTUGAL—MACAU—ARTICLE IV CONSULTATION DISCUSSIONS—POSTPONEMENT

Nothwithstanding the period of three months specified in Procedures II of the document entitled "Surveillance over Exchange Rates Policies," attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board decides that the period for completing the 1998 Article IV consultation discussions with Portugal in respect of Macau shall be until March 25, 1999. (EBD/99/42, 3/11/99)

Decision No. 11918-(99/28), adopted
March 16, 1999

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/99/38, Supplement 1 (3/12/99) and by an Assistant to Executive Director as set forth in EBAM/99/41 (3/12/99) is approved.

APPROVAL: May 14, 2001

SHAILENDRA J. ANJARIA
Secretary