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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/92

10:00 a.m., September 4, 2002

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance

H. Köhler, Chairman
A. Krueger, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A.S. Alosaimi
	A.A. Al-Nassar, Temporary
	D. Ondo Mañe
	E. Nyambal, Temporary
I.E. Bennett	N. O'Murchú
M.J. Callaghan	
R.F. Cippà	
K. Bischofberger	
P.C. Padoan	H. Vittas
D.I. Djojosubroto	Low K.M.
Y.V. Reddy	R.A. Jayatissa
W. Kiekens	M. Marques, Temporary
	B. Andersen
	M. Lundsager
P. Duquesne	S. Boitreaud
A. Mirakhor	S. Rouai, Temporary
A.V. Mozhin	A. Lushin
	E. González-Sánchez, Temporary
	M.A. Brooke
	D. Taylor, Temporary
M. Portugal	R. Steiner
	I. Usman
	G.M. Campos, Temporary
	M.B. Chatah
Wei Benhua	Wang X.
	Jin Z., Temporary
J. de Beaufort Wijnholds	Y.G. Yakusha
	H. Litman, Temporary
K. Yagi	H. Toyama
A.G. Zoccali	G.R. Le Fort
	J.A. Costa, Temporary
	D. Vogel, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
Z.R. Ahmed, Assistant
Y.P. Chia, Assistant
P. Cirillo, Assistant
J. Puig, Assistant

Also Present
ECB: G. Grisse. IBRD: B.Esdar, Poverty Reduction and Economic Management Network Office; B. Mierau-Klein, Credit Risk Office; H. Zaman, South Asia Region Office. WTO: J. Hancock, Trade and Finance Division. African Department: N. Kirmani. Asia and Pacific Department: Y. Horiguchi, Director; R. Al-Mashat, S. Dunaway, D. He, J.S. Lee, H. Shishido. European I Department: L. Kodres, M. Takeda, S. Thakur. European II Department: M. Shadman-Valavi. External Relations Department: T.C. Dawson, Director; G. Hacche, Deputy Director; Y. Kamata, S. Nardin, K. Primorac, P. Reynolds, B. Sarr. International Capital Markets Department: H. Tran, Deputy Director; W.E. Alexander, C. Blitzer, M. Fisher, M. Gapen, C. Medeiros, J. Roaf, M. Singh, K. Srinivasan, M. Vera-Martin. Legal Department: W.E. Holder, Deputy General Counsel; S. Hagan, T. Laryea, Y. Liu, C. Ogada, N. Rendak. Middle Eastern Department: M. Zavadjil. Monetary and Exchange Affairs Department: W. Fonteyne, E. Frydl, I. Otker-Robe. Policy Development and Review Department: T. Geithner, Director; M. Allen, Deputy Director; L.J. Lipschitz, Deputy Director; T. Arvanitis, N. Blancher, L. Ebrill, A. Feler, M. Gilman, M. Hadjimichael, A. Kapteyn, R. Kincaid, A. MacArthur, M. Mecagni, M. Mlachila, J. Nystedt, J. Rahman, B. Setser, S. Singh. Research Department: K. Rogoff, Economic Counsellor and Director; T. Bayoumi, X. Debrun, M. MacFarlan, J. Morsink, D.J. Robinson, S. Tokarick. Secretary's Department: L. Hubloue, M. Miller, P. Ramlogan. Western Hemisphere Department: D. Lombardo. Office of the Managing Director: A.A.E. Bertuch-Samuels, Special Advisor; V. Read, Personal Assistant; R. Moghadam, R. Nord, S. Tiwari, A. Tweedie. Office of Budget and Planning: H. Young. Advisors to Executive Directors: I. Ábel, M.A. Ahmed, A.S.F. Atoloye, E. Azoulay, M. Beauregard, M.P. Bhatta, S. Çakir, W.-D. Cho, B. Couillault, S.S. Farid, P.R. Fenton, F. Haupt, A.R. Ismael, K. Kanagasabapathy, D. Lewis-Bynoe, Liu F., J. Mafararikwa, T. Miyoshi, J. Milton, A. Monajemi, L. Palei, H.E. Phang, K. Sakr, A.A. Tombini, F. Vermaeten, F. Zurbrügg. Assistants to Executive Directors: M. Abbing, C. Adam Gust, S. Alcaide, V. Bhaskar, J.G. Borpujari, V. de los Santos, M. Di Maio, N. Epstein, H. Fabig, C.J. Faircloth, N.H. Farhan, M. Faulend, R. Gauba, C. Harzer, H.-H. Jang, C. Josz, T. Komatsuzaki, A. Lanza, P. Lathouly, Y. Lissovolik, R. Maino, T. May, P. Moreno, T.P. Nguema-Affane, J.W. Ralyea III, A. Rambarran, L. Rizzotti, T. Segara, T. Sekine, B. Siegenthaler, J. Sipko, T. Skurzewski, A. Stuart, S. Vtyurina, D.B. Waluyo, Yu J., I. Zakharchenkov.

1. SOVEREIGN DEBT RESTRUCTURING MECHANISM—FURTHER CONSIDERATIONS

Document: Sovereign Debt Restructuring Mechanism—Further Considerations (EBS/02/151, 8/14/02)

Staff: Fisher, ICM/PDR; Allen, PDR; Hagan, LEG

Length: 2 hours

The First Deputy Managing Director (Ms. Krueger) submitted the following statement:

> The paper before Directors today is a step in responding to a request from the IMFC that the Fund continue to examine the legal, institutional, and procedural aspects of the two proposals to improve the process of sovereign debt restructuring. Previously we have discussed papers on collective action clauses. I hope that today we can carry forward the discussion of the SDRM, by focusing on two specific issues: the scope of debt to be covered by the mechanism and the dispute of resolution procedures. I am looking forward to hearing the views of Executive Directors.
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> It is generally accepted that in cases in which a member has an unsustainable debt burden there is a need to reach agreement with creditors on a restructuring that, taken with appropriate policies, provides a basis for a return to medium-term sustainability. There is also a growing recognition that there is a need to improve existing debt restructuring mechanisms. The SDRM seeks to provide such an improved mechanism, by establishing incentives for a debtor and its creditors to move expeditiously toward a restructuring that both allows debts to be aligned with payment capacity and preserves asset values. It is intended to provide a mechanism for the resolution of collective action difficulties associated with agreements on restructurings, as well as temporary limitations of the enforcement of creditors' claims and the provision of priority financing.
>
> As we develop our approach to the SDRM, we have continued to benefit from constructive discussions with Executive Directors, and a wide range of interlocutors drawn from the official community, academia, and the private sector. The perspectives of country authorities, participants in capital markets, as well as those versed in the experience of debt workouts have helped us refine our understanding of the issues, and approaches to the design of the mechanism. Inevitably, as we move beyond the general framework, the issues become complex, and on occasion, somewhat technical.
>
> Our earlier discussions examined a framework for the mechanism in which key decisions—the approval and extension of the stay on litigation;

provision of priority financing on a senior basis; and the approval of restructuring proposals—would be approved by an affirmative vote of a qualified majority of creditors. As we go beyond this general principle, questions arise as to the scope of debt that would need to be covered by the SDRM in order for it to be effective in facilitating an orderly restructuring, as well as achieving key policy objectives, relating, for example, to the continued operation of the domestic banking system.

Indeed, when considering the scope of debt to be covered under the SDRM, it is necessary to balance a number of different objectives. On the one hand, the mechanism must be sufficiently comprehensive to facilitate an orderly restructuring of debt to a sustainable level, while paying due regard to addressing the intercreditor equity concerns in order to mobilize broad support. Moreover, in order to address collective action problems effectively, the voting provisions must provide for sufficient aggregation across instruments. On the other hand, the mechanism must pay due regard to the fact that not all creditors are similarly situated and that, therefore, equity may require differentiation among creditors. In addition, differentiation may be necessary from an economic policy perspective, particularly where a significant amount of debt is held by the domestic banking system.

The paper identifies two different techniques that can be used to balance these objectives with respect to different categories of debt.

The first would involve including a category of debt under the SDRM as a separate class. Support by a qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. While votes would be aggregated across instruments (thereby greatly reducing the leverage of holdouts), there would be no aggregation of votes across classes. However, since all classes would be required to approve the overall restructuring, each creditor class would have an effective veto over the overall terms of the restructuring. Finally, while all creditors within the same class would need to receive the same restructuring terms, treatment of creditors across classes could be different.

The second technique would be to exclude a certain category of debt from the SDRM on the understanding, however, that, this debt could be restructured through pressure exercised by creditors whose claims are covered by the SDRM. As a condition for voting in favor of a restructuring of their claims under the SDRM, these creditors would insist that any debt that is not covered by the mechanism be restructured in a manner that addresses their concerns regarding intercreditor equity.

With respect to the treatment of domestic debt, the paper addresses two different questions. First, are there circumstances where domestic debt will need to be restructured in order to achieve medium-term sustainability?

Second, if such circumstances do arise, how can the SDRM be designed so as to ensure that this debt is restructured in a manner that pays due regard to its special features?

On the first question, it seems likely that in most cases, it will be necessary to include domestic debt, both to produce a reduction in the debt and debt-service burden of a sufficient magnitude to achieve sustainability, and in order to achieve adequate intercreditor equity to garner broad creditor support. We have listened carefully to those who have argued that the behavior of resident investors, or the characteristics of local currency-denominated instruments, could justify some differentiation in the treatment of certain claims. With the progressive increase in capital mobility as members become more integrated into global capital markets, however, and with limitations on the availability of domestic financing within the framework of a monetary program, the scope for any such differentiation appears to be limited, and likely to diminish over time. Nevertheless, this would obviously need to be examined on a case-by-case basis. Of course this does not distract from the need to consider how best to ensure the continued functioning of at least a core of the domestic banking system and the operation of the payment and settlement system.

With respect to the second question, the paper identifies alternative approaches. Under one approach, domestic debt (i.e., debt governed by domestic law) would be included within the SDRM as a separate class. Under the alternative approach, although this debt would be excluded from the coverage of the SDRM, it could be restructured—where necessary—through the exertion of pressure by creditors holding claims that are subject to the mechanism. As noted earlier, such creditors could make a restructuring of domestic debt a condition for their support for a restructuring of their own claims under the SDRM. Although each approach has its own advantages and disadvantages, my own view is that the latter approach has more promise. Among other things, it may make it easier for member countries to adopt the SDRM.

The paper also provides a preliminary discussion of possible approaches to the treatment of the claims of official bilateral creditors. Such claims are now restructured under the auspices of the Paris Club, which has demonstrated over more than four decades its effectiveness in providing early support for members' adjustment programs, and its capacity to respond flexibly to changing circumstances. Against this background, one possible approach would be to exclude the claims of official bilateral creditors from the SDRM, while considering possible ways to strengthen the coordination between the Paris Club and private creditors. A second possible approach that warrants careful consideration would bring the claims of official bilateral creditors under the SDRM, but as a separate creditor class. Such an approach would need to be implemented flexibly, and would require some adaptation of the Club's practices so as to allow it, on the one hand, to continue to provide an early signal of support for a member's adjustment program, and on the other, to delay agreement on the final terms of a restructuring until these can be coordinated with the restructuring of the claims of private creditors. Although each approach has its own advantages and disadvantages, I find the arguments evenly balanced, though I have heard the views of a wide range of private sector participants who generally favor bringing the Paris Club debt under the SDRM.

Finally, the paper elaborates a number of features of the dispute resolution forum that could be established under the SDRM. While we envisage that the scope of the authority of this forum would be relatively limited, the Sovereign Debt Dispute Resolution Forum (SDDRF) would play a critical role in safeguarding the integrity of the voting process. In terms of its structure, the manner in which the SDDRF is established should be guided by four principles: independence, competence, diversity, and impartiality. Although I recognize that there are different ways to implement these principles, I believe that the overall framework proposed in the paper establishes a useful basis for our discussion. In general, I am confident that it is possible to establish a dispute resolution forum that is independent—and is perceived as being independent—from the Fund's management and Executive Board.

Mr. Padoan and Mr. Bossone submitted the following statement:

The staff has gotten us used to high quality papers. This paper on the SDRM even stands out compared to the usual high standard, for capacity of vision, depth of analysis, and amplitude of ideas. There is no doubt that important progress is being accomplished in our discussion of the SDRM, and that the range of options available to build up an effective mechanism is becoming clearer and better focused at each step.

Ever since the proposal for an SDRM was flagged by Ms. Krueger, this Chair took a supportive position not only because we thought that a statutory approach to sovereign debt restructuring would make involuntary crisis resolutions possible (and less disruptive) when cooperative attempts failed, but also because we reckoned that the very existence of an SDRM with an appropriate incentive structure could facilitate the willingness of creditors and sovereigns to work out cooperative (PSI) solutions. Appropriate incentives, in our view, include stronger and more rigorous criteria for exceptional access to Fund resources and an SDRM payoff structure that would preserve for both parties the convenience to agree on cooperative solutions before considering SDRM activation.

We would like to comment on the paper's proposals.

First, we welcome the staff's suggestion that the decision whether and when to activate the SDRM should rest exclusively with the sovereign debtor. This, we believe, is by far the best alternative among those so far contemplated (including activation by a majority of creditors or by a third party), considering that none better than the debtor can assess the costs and benefits associated with the suspension of its debt contracts. Moreover, we believe that this alternative would achieve the maximum of transparency and incentive-compatibility: when making their investment decisions, investors would know ex ante that activating the SDRM is an option for the sovereign. On its part, the sovereign would be well aware of the relative costs of exercising the option.

Provided that the incentive structure of the SDRM were right, the risk that the option would make it easier for the sovereign to activate the mechanism, when in fact in a position to continue to service its debt, would be minimized: a rational debtor would not activate the SDRM if the cost of doing so would outweigh the benefits.

Second, we agree with the staff that, once activated, the key decisions to be taken under the SDRM would be left to the debtor and a super-majority of its creditors, while a third party would only verify the procedures adopted to arrive at the agreement and ratify the agreement after verification of its legitimacy, which would become binding in force of the statutory basis of the mechanism. This solution should allay the concerns of those who feared the creation of an all-too powerful third-party agency with conflicting interests.

Third, we agree that the scope of the debt to be covered by the SDRM should be comprehensive enough to: allow the debtor to achieve a sustainable level of debt, as a result of restructuring; ensure intercreditor equity; and allow the debtor to better overcome collective action problems. In this regard, we find it sensible that, at a minimum, the SDRM should include all claims held by private creditors that are either governed by foreign law or subject to the jurisdiction of foreign courts. Yet, while all these criteria should serve as a guide for sound choices, we support the idea that the debtor be solely responsible for determining the scope of the debt to be restructured. Of course, such determination would not happen in a vacuum, since the debtor would have a sense of how the market would react and should thereby be able to make an informed decision. Also, the debtor could rely on the Fund's advice on how the path to debt sustainability would be affected by alternative debt restructuring scenarios. Finally, as noted be the staff, the debtor's determination would be influenced by the willingness of the Fund to support a program based on the underlying restructuring plan.

Fourth, initially the SDRM could be established under the presumption that the domestic debt (as defined by the staff for the purpose of inclusion criteria) would be excluded from coverage, while retaining the possibility for the sovereign to decide otherwise. It is reassuring to notice that this would be consistent with market preferences. The same principle could apply for the Paris Club claims as well, with the understanding, however, that the official bilateral creditors would take a cooperative attitude with the private debt holders in the event of SDRM activation so as to ensure as much comparability of treatment as feasible. While the presumption of exclusion in the case of Paris Club claims might not be in line with market preferences, as suggested by preliminary consultations, it would most likely release the SDRM from the high risk of gridlock that could result from the lack of sufficient coordination between official and private creditors, and from the difficulties arising in assessing intercredit comparability of treatment.

In our opinion, it would be preferable to adopt a gradual approach to the implementation of the SDRM, whereby the SDRM treaty would be initially established under the presumption of exclusion of domestic and Paris Club claims. Once the mechanism were in place, some time would be allowed for it to be tested and lessons from experience could then be used to assess the desirability of moving from a presumption of exclusion to one of inclusion in respect of either type of debt. In this latter case, the debtor and its creditors would have to agree on the exclusion of either or both types of debt.

Fifth, we find that creditor classification would introduce an important degree of flexibility in a debt restructuring exercise under the SDRM, which would allow for taking due account of the diversity of instruments and creditors (or creditor interests). The method itself, however, should be implemented flexibly. Thus, our preference is for a method that would pre-specify certain classes of claims to be included in the text of the treaty but that would also allow for additional classes to be included in individual cases. We concur with the staff that such a method would enable the SDRM to adapt to the evolution of capital markets.

Finally, we support the proposed profile for an SDDRF and its responsibilities, and the principles that should guide its functions, although of course the whole issue will have to be discussed much more in depth. The staff proposal, however, encourages us to believe that the very circumscribed (albeit admittedly substantial) powers envisaged for the SDDRF, should be acceptable to those who initially feared that too much power would be concentrated in a supranational institution.

Mr. Wijnholds submitted the following statement:

I welcome the staff paper and appreciate the energetic manner in which staff is making progress on the specific design of the SDRM proposal. I continue to believe that the envisaged mechanism would be a useful addition to the international financial architecture, and expect that the clarification of its precise scope and design will facilitate the decision making process on the creation of an SDRM. For this reason, I would suggest that staff continue its work on fleshing out some of the details. After we have a sufficiently concrete picture of what the SDRM is going to look like, we can discuss the issue of its establishment.

With regard to the inclusion in the SDRM of the three debt categories distinguished in the paper (domestic debt, foreign debt owed to private creditors, foreign debt owed to official creditors), the following two general principles seem important. First, "if it ain't broke, don't fix it". The mechanism should be targeted to those classes of debt where the restructuring is currently hampered by collective action problems. Classes of debt for which satisfactory restructuring mechanisms already exist should therefore not be included, at least not at this stage. Second, in order to optimize the acceptability of the SDRM proposal to the various parties concerned, it is desirable to avoid being overly ambitious at this stage with regard to the scope of the mechanism. Over time, after the SDRM is created, other debt classes could be included under the SDRM. Perhaps staff could comment on whether it is legally possible (and practically feasible) to extend the scope of debt included in the SDRM after we have gained some initial experience with a rather modest version of the mechanism?

Following these general principles, at the current junction, I believe the SDRM should be limited to foreign debt owed to private creditors. This debt class has proven to be difficult and costly to restructure due to collective action problems. Indeed, problems related to this kind of debt have given rise to the current discussions on debt restructuring and the need for an SDRM.

Like Ms. Krueger (in her preliminary statement), at this stage I would not favor bringing domestic debt under the mechanism. As flagged in the staff paper, the prospect that domestic bondholders, by inclusion in the mechanism (albeit as a separate class), would in effect gain a veto on the restructuring terms of the foreign debt classes could make the SDRM considerably less acceptable to foreign private creditors. Where necessary, domestic debt should thus be restructured outside the SDRM, possibly through the exertion of pressure by creditors holding claims that are subject to the mechanism. The staff paper claims that domestic debt can normally be restructured under local law, in domestic courts, e.g. through changing the laws. Although I accept that this might be true in theory, I wonder whether it would work in practice. Does staff have any examples of countries changing their laws in order to restructure their own domestic debt? I also wonder whether a sovereign changing its own laws in order to avoid paying its debt obligations is a strong complement to an IMF-supported stabilization program.

In the same vein, at this moment, I would not support bringing the Paris Club debt formally under the mechanism. Paris Club restructurings have a long history of being efficient and fair. Therefore there does not seem to be a need to bring official debt under the SDRM. Rather, its inclusion could lead to an undesirable weakening of the position of the Paris Club. In addition, inclusion would effectively mean that private creditors, by threatening to use their veto, would co-decide on the use of public funds by Club members (through 'reverse comparability'). In my view, this ought to remain the prerogative of the governments concerned (this was made clear at last year's Board meeting on Paris Club debt). A further concern is that the integration of the Club restructuring process in the SDRM might threaten valuable principles that are currently applied by the Club, such as consensus decision making, the central role of the 'cut-off date' and the principle of 'comparability of treatment'. For these reasons, I would not support including official debt in the SDRM. Rather, it would be useful to consider other ways to strengthen coordination between the Paris Club and private creditors.

In an SDRM that is exclusively concerned with foreign debt owed to private creditors, it could sometimes be desirable to make a distinction in the treatment of different groups of creditors. Therefore it might be best not to pre-specify certain creditor classes in the text of the SDRM treaty (in line with the points made above) but to allow for the creation of classes, as needed, in individual cases, along the lines suggested in para. 23, second bullet of the staff paper.

Finally, I concur with staff's views regarding the Sovereign Debt Dispute Resolution Forum. This body should operate independently from the IMF-Board, and its powers should be limited to the administration of claims and dispute resolution, as specified in the staff paper. I have no strong feelings with regard to the proposed selection procedure for members of the forum.

Mr. Callaghan and Mr. di Maio submitted the following statement:

Key Points

In designing the SDRM, there is a need to strike a balance between providing flexibility to allow the mechanism to operate in a variety of future circumstances, and providing sufficient clarity and certainty as to how it will operate.

There are significant advantages in providing as much certainty as possible as to the coverage of debt under the SDRM. Keeping the SDRM as simple as possible and focused on the specific collective action concerns which pose the greatest problem for restructurings, may facilitate its establishment. Clarity of the SDRM's coverage may also reduce any adverse impact on investment flows.

It is essential that all claims subject to foreign law be included in the SDRM. However, there seems a reasonable case to allow the creation of different classes within these claims in order to allow for creditors with differing legal and economic claims. This may reduce impediments to reaching a restructuring. However, with the objective of providing as much certainty as possible, it would be preferable to pre-specify the classes of claims.

There are very convincing economic and legal reasons why domestic debt may need to be treated differently to external debt.

We support excluding domestic debt on the basis that (i) the main collective action problem is with external debt, (ii) other arrangements are made to address inter-creditor equity, and (iii) the exclusion of domestic debt is likely to make it easier for countries to support the SDRM.

We see the weight of argument in favor of focusing the SDRM on the collective action problems among private external creditors rather than extending it to official bilateral creditors. There will be a need to improve the timing and co-ordination among all creditors outside the SDRM.

We offer some very preliminary reactions to the proposed sovereign debt dispute resolution forum.

Some Strategic Issues in Designing the SDRM

The issues covered in the paper raise some broad strategic questions that need to be addressed as the SDRM is progressed. Given that we are in unchartered waters, and recognizing that country circumstances may vary widely, this points to designing the SDRM with a wide degree of flexibility. To ensure as much flexibility as possible, the treaty establishing the SDRM could provide considerable discretion to the sovereign debtor in terms of the arrangements for and coverage of the restructuring, with the creditors always able to challenge any proposal by the debtor.

A case can also be made, however, in favor of keeping the SDRM simple and tightly confined to addressing the specific problems that may cause difficulties for sovereign restructurings. In particular, this would probably make it easier and faster to gain consensus among members on the proposed SDRM (a factor the First Deputy Managing Director notes would likely be the case if domestic debt was excluded from the coverage of the SDRM). Furthermore, providing investors and sovereigns with greater clarity and certainty on the potential operation of the mechanism may mean that its establishment will have less adverse impact on investment flows. The risk of this approach is that we find ourselves in circumstances where the mechanism is of limited use.

An alternative approach would be to structure the SDRM such that once it is activated, it covers all of a sovereign's debts. This would be more akin to domestic commercial insolvency arrangements, where in the interests of inter-creditor equity, all debts are covered by the insolvency procedures. But while it is inevitable to make comparisons with domestic commercial insolvency laws, we have to be careful how far we take such comparisons, for sovereign debt restructuring is a different animal to commercial insolvency.

Coverage of Debt Under the SDRM

Categories of Debt

It is perhaps easier to approach the question of the coverage of debt by first identifying what debt must be included within the SDRM in order to address the identified problems that could disrupt a sovereign debt restructuring. As the paper notes, it is important to include claims held by private creditors that are either governed by foreign law or subject to the jurisdiction of foreign courts. Creditors holding claims governed by foreign law have the greatest potential to disrupt a restructuring process and, as such, it is important that the SDRM be available to overcome potential collective action problems with such creditors. Within these claims, however, there seems a reasonable case to allow the creation of different classes to allow creditors with differing legal and economic claims to be treated differently in order to facilitate an agreement.

Having regard to the broader issues raised at the outset, we believe it would be preferable for different classes of debt to be pre-specified as much as possible in order to provide greater certainty to the rescheduling arrangements. While flexibility may be needed to create additional classes of debt depending on the circumstances of each case, we would be interested in further elaboration of the mechanism by which this could be achieved. As the paper notes, while the debtor could have the power to propose differing creditor classes, this could be challenged by the debtor. One downside of such a situation is that it could prolong even further the restructuring process. Guidelines on this classification issue may reduce creditor uncertainty. Furthermore, the use of an alternative class of debt should be subject to some de minimis threshold to avoid the risk of creating a group small enough to be controlled by creditors with a view to blocking a restructuring. As long as the different classes are substantial, the risk posed by allowing a mutual veto would appear to be reduced.

Domestic debt

It seems implausible to argue that there will be no circumstances where a restructuring of domestic debt (or some other form of reducing real claims under domestic law on the government) would not be required to achieve fiscal, and possibly external, viability.

It also seems unlikely that a restructuring of domestic debt will be necessary in all situations. There are some very convincing economic and legal reasons why the treatment of domestic debt may need to be treated differently from external debt. In particular, restructuring domestic sovereign debt is likely to have implications for the strength and viability of a country's banking/financial system, which is critical in the midst of a crisis. Domestic debt warrants separate and careful consideration. In terms of defining domestic debt in economic terms, a split on the basis of currency in which the debt is denominated may be the most significant factor. Where a country has a problem with external sustainability, debt denominated in domestic currency is less relevant since it does not require access to foreign reserves to service. It should not require restructuring unless there is a fiscal sustainability problem. This still supports the view that domestic debt need not be included in the SDRM, but suggests that the issue of exclusion could come down to a case-by-case proposition.

However, as the paper notes, sovereign debt covered by domestic law should be "easier" to restructure than debt subject to foreign laws and legal jurisdictions. Moreover, as noted previously, creditors holding claims governed by foreign law have the greatest potential to disrupt a restructuring process. Given that the SDRM is essentially addressing legal impediments to restructuring, then there is logic in defining the domestic/foreign split in terms of the governing law.

As the paper notes, if domestic debt is determined by whether it is governed by domestic law, the collective action problems that can hinder a restructuring are less of a problem than where the debt is subject to foreign law and the jurisdiction of overseas courts. A sovereign can always alter its domestic law to deal with collective action problems. We note, however, the argument that bringing domestic debt under the ambit of the SDRM may extinguish any residual legal leverage a holder of domestic claims have, for example, through the powers of the constitution.

A key question is whether there are reasons ex-ante to rule out the inclusion of domestic debt in the SDRM, or alternatively treat it as a separate class subject to different restructuring terms. As noted in our opening comment, the issue seems to come down to the advantages of keeping the SDRM as simple as possible and directed at what are perceived to be the main problems, or alternatively building in as much flexibility as possible into the arrangement.

If domestic debt is not brought within the ambit of the SDRM, issues of inter-creditor equity still have to be addressed. The sovereign will need to convince holders of external debt that they are being treated equitably in order to advance a restructuring. The treaty establishing the SDRM could also include the requirement that the debtor must make good faith efforts to ensure equity amongst all creditors.

On balance, we can support a consensus in favor of excluding domestic debt on the basis that: (i) the main collective action problems arise with external debt (on the basis of legal jurisdiction); (ii) other arrangements are made to address inter-creditor equity, and (iii) we expect exclusion of domestic debt may make it easier for countries to support the establishment of the SDRM.

Official Bilateral Claims

When considering the discussion in the paper regarding the possible inclusion of Paris Club debt in the SDRM (or official debt more broadly), it is worth recalling the difficulties that have been encountered in engaging in a substantive discussion on the role of the Paris Club and issues of comparable treatment of private sector claims in the context of PSI. We suspect that this may also be the case in this instance.

Consistent with our view of the treatment of domestic debt, we would prefer to keep the SDRM focused on the issue of collective action problems among private external creditors rather than expanding its mandate to cover official creditors. While inevitably coordination and timing problems between official and private sector creditors will arise, we think that including official creditors within the SDRM would be an excessive solution to resolving that problem. The Paris Club does not need a new legal basis for ensuring collective action among its members. While not dismissing the views of private creditors, we think the history of their concerns over the comparable treatment clause in Paris Club rescheduling may significantly influence their support for the inclusion of Paris Club debt within the SDRM. Providing a private sector veto over Paris Club agreement to a restructuring may undermine the critical role the Paris Club often plays in ensuring that Fund programs are fully financed, and by extension would result in the private sector having a veto over Fund programs.

As the paper points out, excluding Paris Club claims from the operation of the SRDM would still leave the issue of ensuring comparable treatment between private creditors with official claims.

The establishment of the SDRM raises issues regarding sequencing and comparability of treatment for the Paris Club to address. In this context, we agree with the First Deputy Managing Director that improvements are required in terms of the timing, communication, and coordination between different creditor groups outside of the formal mechanism of the SDRM. Guidelines on how to undertake this coordination could decrease further uncertainty.

Features of a Sovereign Debt Dispute Resolution Forum (SDDRF)

Our preliminary view on the features, make-up, and process for forming a possible SDDRF is that:

Despite the complexity of the approach, the forum may still not be seen as fully independent.

The forum should not perform a registry function.

The boundary between rulings on the SDRM and those of national legal systems has the potential to be very messy—as one example, the SDDRF would be required to apply the law of the jurisdiction that governs the claims, yet not be subject to the rulings of the bodies charged with interpreting the law. There will be a difficult balance between applying the laws of different jurisdictions while ensuring that a consistent approach is achieved across sovereign claims governed by different jurisdictions.

There is the important issue of accountability. How do we ensure the SDDRF is held accountable for its decisions?

A forum of 21 seems excessive, a number closer to 15 would allow three working panels and the exclusion of up to 6 members in case of conflict of interest.

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

We continue to support the Fund's efforts aimed at securing a more orderly and transparent framework for sovereign debt restructuring. As we have stated in previous Board discussions, we view the two approaches being considered, namely the contractual and the statutory, as complementary, but not as substitutes. We should move forward on both fronts. We welcome today's well-written paper, which addresses a number of important issues that would need to be resolved to make the statutory approach operational.

We concur with the basic elements required in the Sovereign Debt Restructuring Mechanism (SDRM) as presented in the paper:

The SDRM must provide the appropriate incentives for a sovereign and its creditors to reach rapid agreement on a restructuring that preserves asset values and facilitates a return to medium term viability.

The SDRM should be capable of binding all creditors to a restructuring agreement that has been accepted by a qualified majority of creditors, while paying due regard to the distinct nature of the claims of different creditors.

The SDRM should be effective in enforcement of a stay on creditor litigation.

The SDRM should provide the creditors with assurances that the debtor would implement appropriate policies and would not take measures prejudicing creditor interests during the stay.

The SDRM should facilitate the provision of new financing by assuring the seniority of new money extended in support of a member's program to all preexisting indebtedness.

The sovereign debtor would have the exclusive authority to decide whether and when to activate the SDRM.

We have some concerns, however, with regard to the seventh point made in the paper, under the rationale for the SDRM, which proposes that, once activated, key decisions under the SDRM would be left to the debtor and a supermajority of creditors. While we agree with this general principle, it appears to us that the objective of predictability would be best served if the SDRM would provide certain ground rules, known beforehand, on issues like the activation and maintenance of the stay. Thus, in organizing a qualified majority of creditors, this group of creditors would understand that doing so already signifies their acceptance of certain rules of operation inherent in the SDRM, including the important one related to the activation and the minimum duration of a stay on litigation. The same should apply to the provision of seniority to new financing.

Without repeating the excellent discussion in the paper on the scope of the sovereign debt to be restructured under the SDRM, we would like to make the following observations, which are of a preliminary nature:

We see merit to the creation of separate classes of creditors, where the qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. We also find merit to the approach that would pre-specify certain classes in the text of the treaty but also allows for the creation of individual classes in individual cases. The benefits of the added flexibility inherent in this approach would seem to outweigh the concern that it may require the dispute resolution forum to play a more active role since disputes regarding classification would need to be resolved through that forum.

We agree that, in discussing whether domestic debt should be covered by a restructuring, the critical question is whether the restructuring of the debt in question would be seriously undermined by collective action problems. Accordingly, the most relevant criterion for distinguishing between domestic and external debt is the governing law and jurisdiction of the claim, not that of residency or currency. In general, we agree that in many respects, the sovereign already has the legal tools to minimize the collective action problems that may arise in the restructuring of these claims. Consequently, of the two possible approaches to domestic debt put forward in the paper, both having advantages and disadvantages, we are inclined to the first, which would exclude domestic debt from the SDRM. We are particularly concerned that the inclusion of domestic debt, even as a separate asset class would give domestic debt holders the ability to block an agreement between the sovereign and creditors holding external claims. We also have taken note that consultations with foreign investors to date suggest that they would prefer to have domestic debt excluded from the SDRM.

On the treatment of official bilateral debt: clearly, there are advantages and disadvantages to the two possible approaches presented in the paper, and it is difficult to come to a conclusion without knowing the reaction of the major official creditors. We do note, however, that the discussion in the paper has focused on Paris Club creditors. It is not clear how the two approaches would deal with non-Paris Club official creditors in the context of the SDRM. We would be interested in hearing staff thoughts on how the claims of non-Paris Club official bilateral creditors would be represented in the creditor class and in the decision making process. This question is posed in paragraph 61, but no proposals are presented.

Finally, on the Sovereign Debt Dispute Resolution Forum, we find the proposed role and responsibilities for the Forum reasonable. We fully concur with the basic principles laid out to assure its independence, competence and legitimacy.

Mr. Portugal submitted the following statement:

I wish to thank the First Deputy Managing Director for her preliminary statement and the staff for the paper. Both respond to the IMFC's call that the legal, procedural, and institutional aspects of a statutory approach to sovereign debt restructuring are further examined. While I share the same objectives that inspire the two papers of minimizing the costs of unavoidable debt restructuring for the country concerned, its creditors, and the international community, and despite continuing to examine the issue with an open mind, my position is still essentially the same as in previous discussions. I am still unconvinced that the benefits of the proposed SDRM are higher than its potential costs. I continue to believe that a contractual approach based on greater use of existing collective action clauses for new sovereign international bond issues offers better prospects of practically improving the current process for restructuring sovereign debt. Our chair would not be able to support the proposals contained in the present paper and would like its position to be clearly registered in the Summing Up. Despite such objections, in a constructive spirit, and in line with the IMFC's call for further examination, we would still make some suggestions and comments on various issues under discussion in the hope of facilitating consensus and progress on the topic.

The Rational for the SDRM

The proposal for the SDRM seems to be based on the assumptions that the delay and reluctance of a sovereign to recognize when a given debt position is unsustainable are caused by the lack of a predictable mechanism capable of securing collective action on the part of the creditors, and of offering temporary protection against the enforcement of creditors' rights. We dispute those assumptions. In our view, what makes for the delay in recognizing the unavoidable nature of a given restructuring are the uncertainties surrounding the determination of whether a given debt is sustainable or not, associated with the very high economic costs of a restructuring. Such uncertainties, which the SDRM proposal does nothing to dispel, derive from the great difficulties in making judgments about the future path of variables such as the real interest rate, inflation, real GDP growth, the real exchange rate, and investors' confidence. The reluctance to accept a restructuring is caused by the very high economic dislocation costs and reputation costs associated with such episodes, which again are not addressed by the SDRM.

On the other hand, in our view, holdout creditors, major collective action problems, and creditor litigation do not seem to have been major impediments in past sovereign debt restructurings. These were not significant problems in the 1980s debt crisis, or in the sovereign bond restructurings in Russia, Ukraine, Pakistan, and Ecuador. The Argentinean default does not seem to have been marked so far by this type of problems either. Eight months after the largest emerging market default, the majority of creditors are behaving in a remarkably patient fashion. The main problem in the Argentine default seems to have lain elsewhere: the long time and difficulty for the Argentine government and the Fund to reach an agreement on a macroeconomic program that can be supported by the IMF. In fact, litigation against sovereigns has been a very limited phenomenon in debt restructuring. We unsuccessfully have asked the staff several times on previous occasions to provide empirical documented evidence of the magnitude and nature of the problems they are trying to solve. We repeat that request now and expect it to be treated in a future paper on the SDRM topic.

However, if holdout creditors and litigation represented the major problem for sovereign restructuring that the staff believes them to be, there could be simpler solutions to such a problem with a stricter upholding by the international community of the legal doctrine of the sovereign's immunity. Several practical measures could be considered: the official sector of the country where the case is being litigated could, on a case-by case basis, participate in the legal proceedings as "amicus curia", as it was successfully done during the 1980s debt crisis; the extension to other jurisdictions of the pre-judgment attachment immunity for foreign central bank assets which already exists in the United States and England; the adoption of rules to protect from attachment payments flowing to and from international clearing systems like Euroclear, Clearstream, and DTC . We have presented these suggestions in earlier occasions and asked the staff to evaluate them, unsuccessfully up to now. We repeat this request today.

While the benefits of a SDRM may be small, there is a risk that these benefits may be smaller than its potential costs, the most important of which may be the inducement to restructurings that could otherwise be avoided. The political constituencies both in advanced and developing countries interested in resorting to restructuring to avoid either extending official financing or undertaking domestic adjustment are considerable and might push for restructuring in cases where there might still exist a set of macroeconomic adjustment and additional financing capable of avoiding a restructuring. The combination of the difficulties in assessing debt sustainability with these interests may lead to more restructurings. This, in turn, would have adverse consequences, further reducing the volume of capital flows to developing countries and further increasing borrowing costs.

The paper suggests that the sovereign debtor would have the exclusive authority to decide whether and when to activate the SDRM. That might well be the current intention. However, the experience with other recent initiatives undertaken by the Fund suggests that things that start as voluntary soon turn into encouraged, then presumed, and then mandatory. If indeed the activation of the SDRM would be of the exclusive authority of the debtor, then its success would depend on the opinion of the debtors of the usefulness of the mechanism. We might be engaging on a laborious exercise that debtors do not find useful and would never use, if it will indeed be voluntary. Therefore, I would like to propose that, for the next paper on the SDRM, the staff conducts a survey amongst emerging market sovereign debtors to canvass their opinions about the usefulness and likely use of an SDRM.

For all these reasons, we do not believe that the SDRM would provide for a more rapid, orderly, and predictable debt restructuring mechanism than at present.

The Scope of Debt Under an SDRM

As the staff recognizes, the SDRM becomes simpler as the scope of debt to be covered is narrower. As the staff also recognizes, if the sovereign can effectively restructure a particular category of debt without the assistance of the SDRM because collective action problems are minimal or because there are other means to deal with them, then such category should be excluded from the SDRM.

We continue to believe strongly that domestic sovereign debt should be completely excluded up front from the SDRM coverage. The potential costs of the SDRM are substantially increased by the inclusion of domestic public debt in its coverage. As the staff concluded in an earlier paper (SM/02/67) based on the experience with the recent restructurings, the larger the share of restructured debt held by residents, the larger tends to be the negative adverse impact of a restructuring in the economy. As domestic public debt tends to be held mainly by residents, the costs of such restructuring would tend to be higher.

The staff is particularly unconvincing when it presents arguments in favor of the inclusion of domestic debt. The staff claims that creditors holding claims governed by foreign law are likely to insist, as a condition for approving their own restructuring under the SDRM, on receiving assurances of restructuring of other types of debt in an equitable manner (paragraph 25). I would like to know from the staff why they believe this is likely? It does not seem based on the actual experience with past restructurings of external debt, which in many cases were conducted independently from domestic restructuring. The staff argues that "it is likely that domestic debt will need to be included in a comprehensive restructuring" (paragraph 30). This seems to be circular reasoning since if a restructuring were classified as comprehensive then it would follow that it would likely include domestic debt.

Domestic creditors usually incur in many crisis-related costs, such as higher taxation, lower economic activity, currency devaluation and inflation, which do not affect external creditors. Defining inter-creditor equity between these two classes of creditors is an elusive goal for which the official community does not have adequate tools.

Debt sustainability regarding domestic debt can always be achieved by some combination of fiscal effort and inflation. While inflation is an evil, compared with debt restructuring, it is certainly the lesser of two evils. Therefore, the staff's argument that a reduction in local currency debt instruments engineered through inflation and exchange rate depreciation would be limited by the program's targets seems incomprehensible.

The claim that the distinction between domestic and external debts has been blurred by capital account liberalization should not be exaggerated. Many emerging market countries still do not have full capital account convertibility or maintain restrictions on capital account transactions by residents. Even in the presence of full convertibility, the increasing reliance on floating exchange rate regimes substantially mitigates both the inter-creditor equity problem between holders of external and domestic debt and the incidence of capital flight. Also, residents are more likely to have greater long-term business and other interests for holding domestic debt compared with non-residents, even in the case of full convertibility.

Domestic debt is subject to the sovereign's jurisdiction and is subject to the legislative powers of the sovereign and can be restructured through the domestic judicial system. Therefore, the collective action problems and need of protection from litigation, which form the basis of the rationale for the SDRM, do not apply in the case of domestic debt. We agree with the staff that the governing law—domestic vs. foreign—should be the main criterion used to define domestic debt.

A few emerging markets have managed to create domestic debt markets where they now place most of their borrowing requirements. This is a welcome development that all, including the Fund and the international community, should strive to preserve, as it leads to a smaller demand for external borrowing and official assistance and a smaller likelihood of external crises. In addition to being a source of financing, domestic debt also plays an important role in providing an indirect mechanism of monetary control, which could be jeopardized in the case of the inclusion of domestic debt in the SDRM. Including domestic public debt in the SDRM is likely to undermine seriously the development of national capital markets, to lead to a greater need of external financing, to jeopardize monetary control and to increase the likelihood and severity of external crises.

For these reasons, we are strongly of the view that: (i) the text of an eventual agreement establishing the SDRM should pre-specify all the creditor classes to be covered by the mechanism with no possibility of creation of additional classes; and (ii) domestic debt, i.e., debt governed by domestic law and subject to the jurisdiction of the sovereign's courts, should be excluded from the SDRM. I would like to repeat again that if there is not an up-front and permanent exclusion of domestic public debt from the SDRM coverage it would be impossible to make any consensus-based progress on this topic.

The fact that foreign investors consulted by the staff also prefer to have domestic debt excluded from the SDRM should also be an important consideration in favor of adopting this approach.

The use of Fund conditionality to foster inter-creditor equity, hinted by the staff in paragraph 38, runs counter to the function of conditionality, which is to safeguard Fund resources, and contradicts the current efforts to streamline conditionality. We would not support such use.

We would be in favor of including in the SDRM, as a separate creditor class, official bilateral external debt claims held by Paris Club members. While it may be true that the Paris Club is an homogeneous group of creditors that does not resort to litigation, that it has adapted its practices to changing circumstances, and that its claims in many cases represent a small share of total external debt, these same qualifications also apply to some other private external creditor classes, such as for instance, bank lending. If Paris Club claims were left out, it would be appropriate also to leave out of the SDRM coverage external commercial bank lending. The staff argues that the defining criteria should be the debt's governing law. It would seem appropriate, therefore, that all debt subject to a foreign law be included in the SDRM. I agree with the staff that this would require that a number of existing practices of the Paris Club be modified, such as resuming export credit in the absence of a restructuring, keeping flexibility regarding sequencing of restructuring, accepting majority voting to bind dissenting Paris Club members, and making the Club's Agreed Minutes and bilateral agreements legally binding.

Sovereign Debt Dispute Resolution Mechanism

The staff argues in paragraph 64 that previous Executive Board papers have recognized that an essential feature of the SDRM would be the establishment of a dispute resolution forum, through amending the Articles of Agreement. This language referring to "Executive Board papers" probably means "staff papers presented to the Executive Board", but it may be misleading as it might be interpreted as if the Executive Board had accepted that position, which is not the case. I would ask, therefore, that such language be corrected before the publication of the paper. Indeed, the creation of such a mechanism and especially amending the Articles has been specifically rejected by many chairs. This continues to be our view.

The Fund is a creditor, the main advisor with respect to adjustment policy, and a possible future lender. It will assess debt sustainability and provide advice on economic policy prior, during, and after the restructuring. There are, therefore, too many potential conflicts of interest that would recommend that the idea of a dispute resolution forum, if it were to proceed, be implemented completely outside the Fund. We do not believe it is operationally possible to make such a body to function independently from the

Executive Board, Board of Governors, management, and the staff. If such body is to be independent of any organ of the Fund, I would like to know from the staff why to create it as an affiliate institution to the Fund, rather than a totally separate and independent body from the Fund?

We also continue to maintain it is inappropriate to use the faculty to amend the Articles for the SDRM creation since this relates to objectives that fall outside the Fund's purposes, and were never envisaged by members when they originally subscribed to the Articles. In addition to raising legal issues, this procedure is certainly not an example of good governance. It is an inappropriate way of trying to bind members that would be in the minority opposing the amendment. If an SDRM and SDDRF are to be established, this should be done by a completely new international agreement on this topic rather than by amending the Articles. Our chair would oppose any proposal to amend the Articles of Agreement in these respects.

The staff argues that the SDDRF will deal mainly with administrative powers and that its dispute resolution powers would be limited. Yet there are functions that would clearly not be administrative and would require considerable powers to be discharged. It is envisaged, for instance, that the SDDRF could look into allegations that a sovereign is trying to exercise undue influence over some creditors. This clearly is not an administrative matter, but a political one. What type of evidence would be accepted? Would the SDDRF have investigative powers to inquire into motives of the creditor? What duties of cooperation with the investigation would a sovereign have? In many domestic court systems this type of inquiry into the actions and motives of a sovereign is not permitted. How would the SDDRF actually limit the types of disputes that will be brought to its attention? Will it have to accept any case?

One goal of the SDDRF is legal uniformity, but uniformity itself may be problematic. It may be appropriate to have disputes about trades governed by New York law resolved by a New York tribunal and disputes about trades governed by U.K. law resolved by a U.K. tribunal rather than having all such disputes resolved by a panel composed of experts with no experience on New York or U.K. law. Ideally, all disputes concerning trades governed by a single governing law should be resolved the same way. Would decisions of panels constitute binding precedent for subsequent panels? An initial SDDRF decision that must be followed by subsequent panels may be in stark conflict with a local law decision on the same subject and create uncertainty in markets.

Many of the administrative functions to be performed by the dispute resolution mechanism such as notifying creditors, administering voting, and registering claims have not proven to be difficult in earlier restructurings or can be done by other mechanisms including private entities. Some dispute resolution functions such as the verification of claims to avoid the creation of fictitious claims and the control of the integrity of the voting process would be difficult to perform. The idea that the mechanism would have the exclusive jurisdiction over all disputes arising between the debtor and the creditor and amongst the creditors to the exclusion of domestic courts is far-fetched. Many member countries have constitutional rules that establish that no act or decision may be excluded from oversight of its judicial courts. An amendment of the Articles violating such principle would not be approved by the national parliament as unconstitutional.

The staff expands on rules and principles regarding the composition and choice of members of the dispute resolution mechanism, but does not say anything about the 11-member committee that would short-list the 21 members of the mechanism. Could the staff explain who would choose such committee and what would be its composition in terms of balance between nationals of creditors and non-creditor countries?

Mr. Andersen and Mr. Farelius submitted the following statement:

We would like to thank staff for a high quality paper, bringing us a significant step further in our discussion on an SDRM. As this chair has stated on many previous occasions, we find it important to increase the transparency, efficiency and predictability of the crisis resolution process. In this regard, we reiterate our support for making determined progress in both the statutory and the contractual approaches to improve the process of sovereign debt restructuring, in parallel with the operational improvement and further implementation of the framework for the PSI agreed in Prague two years ago. We concur with Messrs. Padoan and Bossone that the very existence of an appropriate SDRM could facilitate the willingness of creditors and sovereigns to work out cooperative PSI solutions. We also agree with their call for stronger and more rigorous criteria for exceptional access to Fund resources.

The need for enhancing the process of restructuring the debt of a sovereign has been made clear over the past years, not least due to the recent developments in capital markets where bonded debt has become a more and more prominent source of finance for particularly emerging market countries. The SDRM proposal has indeed initiated a lively debate which already has led to a clearer conception of the challenges involved and an increased understanding in financial markets of the need for an orderly debt restructuring process.

In discussing the proposed SDRM, it is important to take into account the already existing mechanisms being able to handle official and domestic debt restructurings. Here, we fully agree with Mr. Wijnholds: "if it ain't broke, don't fix it". Accordingly, at this stage, it seems appropriate to put the emphasis on a so far missing link, namely to set up a structure dealing with foreign debt owed to private creditors in order to ensure a more rapid, orderly, and predictable debt restructuring. With this in mind, we should aim at making the SDRM comprehensive enough to facilitate a debt restructuring of a sovereign to a sustainable level, while paying due regard to the distinct nature of the claims of different creditors. A complete solution to all problems involved seems to be hard to obtain in view of their complex nature. We therefore generally support the simpler alternatives proposed by staff. At this stage, our first priority should be to establish promptly a forum of dialogue and negotiation and a code of conduct that facilitates the restructuring of sovereign debt.

On the technical issues raised in the paper, we agree with staff that a framework of classification between various types of claims seems appropriate. To make the SDRM operational, some flexibility as regards the different types of claims would seem warranted since different types of claims are constantly evolving in the market.

The main purpose of the SDRM is to address collective action difficulties associated with debt restructurings. Since the jurisdiction governing claims determines the extent to which collective action problems might impede the process of a restructuring, it would be straightforward, and in line with the objective of the proposed mechanism, to distinguish between external and domestic debt on the basis of governing law.

While appreciating the complexity of the issue of how to treat domestic debt, there are several factors that would argue against including such debt in the SDRM. Most importantly, the potential effects on the stability of the financial system and the wider implications for economic performance would have to be taken into account. Furthermore, as noted in the document, the potential collective action problems associated with claims governed by domestic jurisdiction should be less severe since there are already mechanisms in place to deal with the restructuring of such claims. Having said that, in some cases it might be rather difficult to ensure debt sustainability and intercreditor equity without including domestic creditors. While we are of the view that domestic debt could be excluded at the initial stage of the SDRM, its later inclusion might be worthwhile to consider, as this could be of significant importance for attracting foreign investors. In any case, it is important that countries be encouraged not to give domestic creditors preferential treatment over foreign creditors holding similar claims.

Regarding the treatment of official bilateral debt, a number of factors would argue against including this type of debt in the mechanism. First of all, and as noted above, there is already a mechanism to handle the restructuring of this type of debt. Second, official bilateral debt is a relatively insignificant part of the sovereign debt in many emerging market countries. Third, including such debt under the SDRM as a separate class would complicate the restructuring process, since these claims would need a special treatment or a restructuring on different terms than privately held bonded debt. On the other hand, including official bilateral debt in the SDRM could strengthen coordination and consultation between private and bilateral official creditors, while taking into account their different interests. However, there are other ways, outside the SDRM framework, to enhance such co-ordination. Given the long experience of successful restructuring in the Paris Club context, we see no need to include bilateral official debt in the SDRM at this stage. In any case, suitable arrangements would have to be found in close consultation with the Paris Club members. We also believe that we should further study the treatment of non-Paris Club official bilateral debt.

We appreciate the need for a dispute settlement body with limited powers and operating independently from the governing structures of the IMF. However, a general remark in this context is that it seems premature to discuss the details of a Sovereign Debt Dispute Resolution Forum (SDDRF) before the exact coverage and nature of the SDRM itself is settled. Although we have no firm position on the selection and appointment procedure the suggested process seems to be overly complicated. Other, more simple ways of selecting members could be considered. We agree that the SDDRF should not challenge decisions made by the Executive Board nor play an active role in the application of SDRM provisions. Furthermore, other ways to set up a dispute settlement body should not be ruled out. For instance, we would suggest exploring the possibility of having a completely independent resolution forum similar to the International Centre for Settlements of Investment Disputes.

In conclusion, we strongly support efforts to increase the transparency, efficiency and predictability of the crisis resolution process and it is our firm belief that an SDRM can further strengthen these objectives. However, since it is clear that it will take time before the SDRM becomes fully operational we would like to emphasize three points. First of all, in order to ensure progress on the crisis resolution framework, intermediate solutions should be promoted in parallel with continued progress in the work on SDRM. More work needs to be done in the areas of PSI and the complementary contractual approach as well as on the clarification of the Fund's lending into arrears policy and implementation of a more predictable and stringent access policy. Secondly, let us not forget that continued efforts on crisis prevention and strengthened surveillance are equally crucial. It is important to identify at an early stage the debt sustainability risks for the public and private sectors and to make proper vulnerability assessments. Finally, we find it important to clarify the legal instruments that may be needed to ensure a statutory legal basis for the mechanism, making the agreement legally binding on all relevant creditors. The question is whether an amendment to the Articles of Agreement would suffice or if changes to member countries' domestic legislation is required. We look forward to discussing these issues in the near future.

Mr. Rustomjee submitted the following statement:

We thank the staff for the very comprehensive, balanced paper on the issue of constructing a Sovereign Debt Restructuring Mechanism (SDRM), and the First Deputy Managing Director for a very helpful accompanying preliminary statement. Both of these documents highlight the progress made to date with efforts to construct an effective SDRM. Nevertheless, substantial issues from past discussions on how to operationalize the SDRM still need to be resolved, and the documents provide in our view, some very useful alternatives in this regard.

Need for an SDRM

We supported during previous discussions the need for a statutory SDRM as an alternative to the voluntary debt restructuring mechanism in cases where a sovereign has accumulated an unsustainable debt burden, and particularly where it is clear that the voluntary approach would not facilitate an expeditious exit to the unsustainable debt situation. The current voluntary debt restructuring process holds in our view both direct costs and indirect costs to the debtor, creditors and third parties. Direct costs accumulate to both the indebted sovereign and the creditors as long as the debt crisis continues. Experience also suggests that other that sovereigns particularly emerging market economies can be both directly and indirectly effected by such a crises as a result of contagion and the closure of international capital markets. We therefore continue to support efforts to construct an SDRM, which would ensure a rapid, orderly and predictable restructuring process.

Scope of an SDRM

The staff provide us with alternative categories of debts to be included in an SDRM framework, namely, foreign debt owed to private creditors, domestic debt and foreign debt owed to official creditors. Firstly we believe that an SDRM would at present be useful to deal with only foreign debt owed to private creditors, particularly since this kind of debt is the most difficult to deal with in cases where debt restructuring is needed. Secondly, as regards domestic government debt we continue to hold the view that this kind of debt should not the included in a new SDRM, since sovereigns generally possess sufficient tools to deal with this category of debt; and also because the restructuring of domestic debt needs to be closely aligned with other areas of domestic macroeconomic policies. We observe in the staff paper that private sector actors with whom discussions were held on this issue, also share the view regarding the exclusion of domestic debt from a SDRM. Finally, as regards the inclusion of Paris Club debt under a new SDRM, we could also not support this proposal. As noted in the staff paper, the Paris Club mechanism has a long history in dealing with unsustainable debt of sovereigns. Furthermore, its modus operandi is based on consensus, unlike the proposal for a new SDRM, which would deal with the debtor country and a super majority of creditors. That said, one of the particular challenges which several of our Constituency members grapple with is the case of HIPC-to-HIPC and HIPC-to-non-Paris Club member debt. It is the strong expectation that the proposed new SDRM will also facilitate an early resolution to this challenge, which is of serious concern to our members.

On the basis of these comments, we would therefore support the view that an SDRM should initially establish a framework to deal with the unsustainable sovereign debts due to private external creditors only at this time, before we proceeding to include other classes of debt.

Activating the SDRM

We fully support the proposal that the concerned debtor has the exclusive prerogative to activate the SDRM. The following considerations motivate our support. Allowing only the sovereign debtor to activate the SDRM would respect the sovereignty of the debtor as regards its international relations. In addition, by affording the sovereign debtor the sole prerogative to activate the SDRM, this will enhance the ownership of policies to be adopted in the process of undergoing a debt restructuring process. Furthermore, like Mr. Padoan and Mr. Bossone, we consider that the sovereign debtor is in the best position to ascertain the benefits and the costs associated with the suspension of debt contracts. Once the process has been activated the concerned debtor and a super majority of creditors should be allowed to negotiate the terms of the debt restructuring, with a third party only involved in verifying the legitimacy of the process.

Creditor Classification

We support the notion of creditor classification to increase the flexibility of an SDRM framework, particularly given that creditors' interests and instruments vis-à-vis debtors differ. In this regard, the inclusion of a pre-classification of creditors in a treaty should be encouraged. Nevertheless, allowance should be made for including other classes of creditors, not originally included in such a treaty. The term "creditors" should therefore be broadly interpreted if included in any such treaty.

The Sovereign Debt Dispute Resolution Forum (SDDRF)

The establishment of an SDDRF along the lines proposed in the staff paper is a novel idea, which we can support. We are particularly in favor of an organ, which would operate independently from the IMF Board and Management, with clearly defined, but limit powers. We also support the proposed selection criteria of members to this forum.

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

Reducing the incidence of debt restructuring episodes and their social and economic consequences by providing for an orderly resolution of external crises constitutes, clearly, a worthy objective. We welcome the staff's paper revisiting the rationale for the operation of the Sovereign Debt Restructuring Mechanism and for the expanded range of ideas for an effective debt-workout exercise and the well-focused comments in the First Deputy Managing Director's statement (BUFF/02/131). We see merit in seeking greater clarity on two of the most important issues involved, namely the scope of the debt to be covered and the dispute of resolution procedures, keeping in mind the concerns raised at our last Board meeting on this issue. We remain of the view that the statutory and the contractual approaches are complementary elements to be refined in order to assure a feasible mechanism for the resolution for sovereign debt crises. Providing the basis for a rapid return to medium-term sustainability, however, calls for further work not only on the resolution of the stock problem but also on the flow issues, in particular those linked to the nature and dynamics of regaining access to voluntary market financing.

The further considerations on the legal, institutional and procedural aspects of the statutory approach, in particular the recognition of the existence of extreme cases involving unsustainable debt burdens and the shift away from syndicated commercial bank lending are helpful to build consensus. In this regard, the appropriateness of the incentive structure–including adequate access to Fund resources even before considering SDRM activation—is key to the formalization of a cooperative PSI framework.

The coordination problems arising from the diversity of claims, demands and interests justify a thorough cost-benefit analysis that includes, among others, the impact of seniority clauses in sovereign debt instruments and the implications and treatment of non-sovereign debt. We consider that the existence of a sovereign debt resolution mechanism does not by itself guarantee a solution to the creditor coordination problem. Early and smooth channels of communications between debtors and creditors, aimed at avoiding forced outcomes and at facilitating binding majorities should figure prominently. Otherwise, the mere existence of the SDRM may leave a sovereign no other recourse than to seek a comprehensive debt restructuring. Care should be taken to ensure that an eventual SDRM not lead to a restructuring case that might have been avoided with continued adjustment and more temporary official financing. At the same time, debt sustainability is also predicated on the assumption used for macroeconomic variables and the signaling that is so important for investor confidence in a world where informational asymmetries and self-fulfilling prophecies also matter.

Against this backdrop, staff's suggestion that the sovereign debtor is cognizant of the full costs of exercising the option and has the exclusive authority to activate the SDRM is correct, but rather detached from the market dynamics once the pressure of unsustainability, for whatever reason, has established. While this option could facilitate transparency and incentive-compatibility, the need for continuing support from the Fund during the restructuring process–in the context of its lending into arrears policy-remains key for an orderly process of economic adjustment and debt restructuring.

Staff notes that once activated, some key decisions, such as the terms of the debt restructuring and the legal protection for the sovereign under the SDRM, would be left to the debtor and a super-majority of its creditors. In this regard, the framework would still lack full predictability. Moreover, we tend to concur with Mr. Shaalan and Ms. Farid that the objective of predictability would be best served if the SDRM provides certain ground rules on issues like activation and maintenance of the stay.

On the scope of debt to be covered under the SDRM, striking the right balance between allowing debtors to overcome collective action problems, to attain a sustainable level of debt after restructuring, and intercreditor equity concerns is a complex undertaking. In this regard, the differences among creditors point to the desirability of their proper differentiation. A creditor classification that entails a certain degree of flexibility taking into account the diversity of instruments and creditor-specific classes of claims would be most in keeping with the evolution of capital markets. At the same time, the creation of creditor classes could anticipate a potential risk associated with demarcation.

The debt restructuring framework should envisage sufficient flexibility so as to allow the sovereign debtor concerned to determine the categories of debt to be excluded in light of country-specific circumstances. In this regard, the necessary Fund technical assistance should be available in order to move forward an efficient debt classification consistent with the need to reduce the service.

Consistent with market preferences, we see merit in the proposal to exclude the domestic debt from SDRM coverage-unless requested by the sovereign in view of the country-specific circumstances. Similarly, in the event of an activation, we believe that coordination between official bilateral and private creditors should be pursued in as cooperative a manner as possible, and preferably, within the SDRM framework.

On a preliminary basis the proposed powers and composition for the Sovereign Debt Dispute Resolution Forum (SDDRF), raise a number or issues. The principles behind it to achieve an independent, competent, diverse and impartial forum and preserve an equitable collective framework to resolve disputes between debtors and creditors are reasonable and appropriate. Nevertheless, the required amendment of the Articles of Agreement would make it incumbent to discuss all aspects impinging on its independence, including the relationship between the Fund's Board and the SDDRF to ensure predictability and accountability in the administration of claims. Finally, we should underscore that the main emphasis of the Fund's work in this domain should remain on crisis prevention rather than on crisis resolution and we caution against a tendency to equate the SDRM with crisis resolution given the stock/flow considerations mentioned earlier and other non-procedural factors impinging on the appetite for risk and the debt dynamics. A real test of our success will be the ability of the international community to avoid relying on the eventual activation of the SDRM.

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

We welcome a new round of discussions on the Sovereign Debt Restructuring Mechanism. Before we proceed to more specific comments on the issues for discussion, we would like to make several general comments. First, we consider the active participation of the private sector in shaping the SDRM to be essential for its success. It could have been useful for the Fund before the Board discussion to seek comments on this paper from professionals with significant experience in sovereign debt restructuring and to distribute such comments to directors before the Board meeting. In our view, in case of the SDRM, the staff should go beyond occasional references to the reaction of outsiders and, instead, provide a comprehensive description of the alternative views and arguments. Such an approach would have enriched the discussion. Given that the paper is intended for publication and broader discussion, at this stage, we can offer only preliminary comments.

The high sovereign debt burden is rarely the only impediment to an economic recovery in a country. Instead, a debt crisis is usually the result of a prolonged period of misguided economic policies, and debt restructuring is necessarily a part of a more comprehensive reform agenda. The latter is usually difficult to formulate quickly since it requires not only the technical expertise, but also political and social consensus. From this perspective, it would be a mistake to exaggerate the role of a more organized and streamlined process of sovereign debt restructuring in rapid resolution of an economic crisis. The benefits of the proposed SDRM, if it were implemented, would probably be rather limited, although important. One of the obvious benefits would be the imposition of constraints on the activities of holdout creditors and, as a result, more equitable burden sharing among homogeneous creditors.

We agree with the staff on the need to preserve flexibility for the debt workouts under the SDRM. As we have already stated previously, the number of defaults on sovereign debts is small compared to the number of corporate debt restructurings under national legislations. Hence, there is an obvious lack of "case law"—the fact frequently mentioned at the Board discussions on the related subjects. Under such circumstances a larger degree of ambiguity with respect to the rules used in sovereign debt restructuring appears to be inevitable. One corollary of this statement is that for the sake of reaching a broadly based compromise between various creditors and the debtor, a sufficient room for flexibility should be retained under the SDRM. We appreciate the effort by the staff to come up with operational solutions that attempt to address this concern. The second result is that, in the sovereign debt restructuring, the same reason predetermines much more prominent roles for the debtor and for the representatives of creditors, while the role of the dispute resolution body has to be facilitating rather than prescriptive.

Turning to the main issues for discussion, we tend to share the pragmatic position of the First Deputy Managing Director on the treatment of the domestic debt. We agree with the view that domestic debt should be outside the scope of the SDRM, and that, if necessary, creditors can probably insist on its restructuring through the use of carefully designed conditionality.

There are many arguments against as well as in favor of inclusion of the Paris Club claims into the SDRM. On the one hand, the nature of bilateral official financing differs from that of the private capital flows. Official financing is also less volatile and poses virtually no danger of aggressive litigation. At the same time, the insistence of the official sector on private sector involvement and calls for close cooperation between the official sector and private sector in resolution of the crises necessarily raise the issues of equitable burden sharing. It is especially true for the countries where official claims account for a large share of the sovereign debt. The recent steps taken by the Paris Club to enhance transparency in its decision-making were aimed at addressing serious concerns of the private sector. As the staff pointed out in their paper, the possible inclusion of the official bilateral claims into the SDRM would imply significant departure from the current Paris Club process. Still, if sufficient support can be secured from the Paris Club, cooperation between the private sector and the Paris Club within the SDRM could probably provide a workable format for discussions. However, the staff report provides few details on possible modalities of such cooperation. Moreover, it would be useful to present more explicitly the arguments of the private participants insisting on the inclusion of the official bilateral claims into the SDRM. Similarly, we need to know the reaction of the Paris Club to such a proposal. At this stage we are not prepared to support any of the proposed alternatives.

For successful debt restructuring an appropriate degree of differentiation among creditors is necessary. Besides the decision on the exclusion of certain claims from the SDRM, the classification of claims covered by the framework seems to present a special challenge. While we tend to favor a more flexible approach described in paragraph 23 of the staff paper, more details about the procedures used for identification of creditor classes are needed and the opinion of private sector would be especially valuable in this area.

We are rather comfortable with the idea of certification by the SDDRF of the agreements reached by the debtor and its creditors. We are open to the SDDRF performing administrative functions, although we also believe that creation of a private entity for these purposes should be explored further. We have more reservations about the envisaged modalities of dispute resolution. Our general preference is to limit the discretionary powers of this entity. For example, for verification purposes the SDRM could rely more on the decisions of the courts in relevant jurisdictions, while to ensure the integrity of the voting process, instead of empowering the SDDRF with responsibility to exclude certain creditors from voting, one could think of requiring a higher majority of creditors to validate the proposed decisions. Also, before we endorse any particular way to select the members of the SDDRF, we would like to see the alternatives to the single approach described in the staff paper.

Mr. Bennett submitted the following statement:

Key Points

The SDRM is a key component of a comprehensive international framework for crisis prevention and resolution. And as such, its effectiveness is inextricably tied to the effectiveness of the other components of the framework.

Further outreach is needed by the IMF, as well as its shareholders, to engage the private sector and emerging market sovereign borrowers in developing a more concrete set of recommendations, while at the same time, obtaining the necessary "buy in".

Logically, I think that all sovereign debt—domestic, private foreign, and official bilateral—should be subject to the SDRM.

However, I can support a more narrow initial focus on private foreign debt, provided adequate safeguards are put in place to ensure fair treatment of all creditors and inter-creditor equity.

The proposed role of the Fund in the formation of the SDDRF could still reasonably be seen by some interested parties as too large.

We see the SDRM as a key part of an integrated and comprehensive international framework for crisis prevention and resolution. The policy on lending into arrears to be discussed later today and access policy in capital account crises to be discussed on September 6, are other key parts of the framework. The overarching goal of this framework is to achieve efficient international capital markets in which lenders bear the consequences of their investment decisions, characterized by undistorted assessments of risk and return, and payments problems are resolved in a timely and transparent manner. It is essential to recognize that the effectiveness of each of the parts of the framework depends on the content and application of the other parts. To give a concrete example, it may be difficult to credibly commit to greater discipline in adhering to access limits in the absence of tools that facilitate a rapid and orderly restructuring of sovereign debts if the implication is undue domestic adjustment. Conversely, progress toward establishing a sovereign debt restructuring mechanism will contribute little toward better overall crisis management if a willingness to provide exceptional financing obfuscates the need for restructurings.

The conception of the SDRM has evolved considerably over time, notably with respect to limiting the role of the Fund in the mechanism. We are encouraged by the ongoing work on the SDRM, but I must say that my authorities are uncomfortable in taking concrete decisions on the modalities of the SDRM at this time on the basis of the limited outreach that has taken place to date. In many quarters the SDRM is a highly controversial concept and what the IMF is trying to achieve is not well understood. While I do not wish to minimize the considerable informal outreach already undertaken on this proposal, it is important that the Fund take the time to adequately consider the concerns and suggestions of all interested parties. If private "foreign" lenders, for instance, are left with the perception that the SDRM is creating a risk that they will be treated unfairly in debt restructurings, and/or that the SDRM will encourage unwarranted restructurings, emerging market borrowers may pay a high price in terms of less access to capital and higher spreads. The views that I express today are subject to revision on the basis of new information emerging from additional outreach. We look forward to a more structured outreach effort and further refinement of the proposal.

The Scope of Sovereign Debt Under the SDRM

Logically, I think that all sovereign debt—domestic, private foreign, and official bilateral—should be subject to the SDRM. That would ensure both that sufficient debt is covered for the restructuring to ensure sustainability and to safeguard inter-creditor equity. Moreover, while I agree with the staff that the debtor has the capability of restructuring debt subject to its own jurisdiction without recourse to the SDRM, I am reluctant to encourage this. Changes in laws governing domestic debt that appear to differ significantly from what is agreed in the context of the SDRM could seriously harm the investment climate in the country. And including official bilateral debt should not hamper the Paris Club in any fundamental way as the Paris Club has always been firmly committed to fair treatment of all creditors.

Nevertheless, I recognize that at this juncture a consensus seems to be building that, initially at least, the SDRM should only be applied to private foreign debt. Subject to the concerns about outreach expressed above, we can join this consensus, provided adequate safeguards are put in place to ensure fair treatment of all creditors and inter-creditor equity. Specifically, it should be clearly stated in the text of the treaty that creates the SDRM that debtor countries availing themselves of the SDRM must provide all creditors with all relevant information on a timely basis. Moreover, there should be a provision that a restructuring agreement could be reopened at the request of a class of creditors should it become clear that there has been a fraud in the process.

I would note that to a large extent, the paper envisions the SDRM as a tool for debtors to use at their discretion—the debtor triggers the mechanism, and has latitude to restructure some credits outside the mechanism before invoking it and to decide the classes of creditors. This flexibility could create the perception that the SDRM tilts bargaining power in restructuring excessively in the direction of the debtor, undermining the mechanism's perceived fairness, and hence legitimacy. To be effective not only must the SDRM be impartial and fair; it must be widely perceived to be impartial and fair. The informal consultations that have been held with emerging market borrowers, NGOs, and private creditors have been helpful in this regard. But there is a need for further more structured outreach by the IMF, as well as its shareholders, to engage the private sector, emerging market sovereign borrowers, and NGOs in developing a more concrete set of recommendations, while at the same time obtaining the necessary "buy in". The staff could then return to the Board with clear recommendations, and accompanying rationales, which could then be evaluated by the Board in a manner informed by members' own outreach efforts.

Before concluding this section, I would also note that it is important that, if the decision is taken to create classes of creditors for each, of which a qualified majority is required for the approval of a debt restructuring using the SDRM, that due care be taken in setting the classes to avoid introducing a new collective action problem.

Sovereign Debt Dispute Resolution Forum (SDDRF)

The current proposed structure of the SDRM still has the IMF in a prominent legal/judicial role, notwithstanding the proposed "independence" of the SDDRF. In our view, the Fund's role in selecting the committee that vets the members of the forum and eventually approving the slate of members could be a focus of criticism and undermine the Forum's legitimacy. I wonder if there might be useful lessons for addressing the inherent concern about Fund impartiality in the way in which the members of existing international legal forums, such as the World Court and UNCITRAL, are chosen.

Conclusion

While there is much valuable food for thought in this paper, we are still some distance from being able to make concrete decisions about how the SDRM will operate. I encourage the staff to consult in a more structured way with parties that have an interest in the SDRM and report back to the Board as the next step in taking the needed decisions. I would also encourage the staff to give more thought to safeguards that could be included in the SDRM to ensure reasonable inter-creditor equity and to deal with instances of fraud.

Mr. Al-Turki submitted the following statement:

Key Points

An appropriately designed and implemented SDRM could help reduce costs of restructuring for both sovereign debtors and their creditors.

Creating classes in the context of the SDRM is appropriate, but defining these classes narrowly could complicate the restructuring process.

I see merit in excluding domestic and official bilateral debt from the SDRM.

I can go along in principle with the proposals regarding the composition and powers of the Sovereign Debt Dispute Resolution Forum (SDDRF).

I thank management and staff for their efforts to further advance the discussion on the Sovereign Debt Restructuring Mechanism (SDRM). The staff paper, though only focused on two specific issues, clearly highlights the complexities involved in operationalizing the SDRM. Indeed, the complexities will likely increase further as we go deeper into the details. That said, let me make few comments on the issues raised in the paper.

An appropriately designed and implemented SDRM could help reduce costs of restructuring for both sovereign debtors and their creditors. However, as I noted on previous occasions, it is clear that most countries will do their utmost to avoid debt restructuring and the associated economic, social, and political costs. Thus, SDRM may not be used at an early enough stage to achieve the maximum benefits.

I agree that creating creditor classes in the context of the SDRM provides a good balance between the need for comprehensiveness of debt to be covered under the mechanism, addressing intercreditor equity concerns, and recognizing that not all claims are the same. It should be noted, however, that the more classes of creditors that are created the more protracted the negotiations are likely to be. Indeed, creation of narrowly defined classes combined with the ability of each class to veto the restructuring will make it easier for an investor to acquire a blocking share in one of the classes. This could be used to either obtain more favorable terms or derail the whole restructuring effort.

Good arguments could be made for distinguishing between domestic and external debt on the basis of currency of denomination or the governing law. The staff suggests the latter and I can go along especially since the coverage of debt under either approach would be very similar in most cases. Indeed, debt governed by domestic law is usually denominated in domestic currency and therefore will suffer substantial losses due to exchange rate depreciations resulting from a crisis. These losses need to be taken into consideration in any restructuring, whether domestic debt is included or excluded from the SDRM. In view of the nature of domestic debt, the flexibility the authorities have in restructuring this debt, and the complications that could result from including it under the SDRM, a case could be made to exclude this debt. On the other hand, excluding the domestic debt from the SDRM could further disadvantage holders of domestic debt as they will lose the veto power on debt restructuring accorded external creditors. On balance, however, I lean towards excluding domestic debt from the SDRM.

Turning to the more thorny issue of dealing with official bilateral claims in the context of the SDRM, it is clear that subjecting those claims to the SDRM will create a new set of issues that needs to be resolved. In addition to the legal issues this approach may create in the various countries, inclusion may lengthen the restructuring process especially if parliamentary approval in creditor countries is required to approve the restructuring. However, it could be argued that it may not be fair for the official sector to ask the private sector to be subject to an SDRM while exempting itself from the process. Taking all these factors into account, I see merit in simplifying and expediting the restructuring process by excluding the official bilateral debt from the SDRM.

Finally, I can go along in principle with the proposals regarding the composition and powers of the Sovereign Debt Dispute Resolution Forum (SDDRF). Limiting the powers of the SDDRF to dispute resolution and administration of claims appears reasonable. The selection and appointment procedure set forth in the paper should help ensure that the SDDRF is independent from the IMF Board.

Mr. Yagi and Mr. Miyoshi submitted the following statement:

Key Points

The idea that the scope of debt for the SDRM should be sufficiently broad is understandable, given the SDRM's potential to deal with collective action problems effectively and to achieve comprehensive debt restructuring in an orderly manner. However, including a wide range of debt into the SDRM could also have disadvantages in that a complex framework would be necessary in order to ensure flexibility to differentiate the treatment among creditors. We should be realistic and have a balanced view on these advantages and disadvantages in examining the scope of debt for the SDRM.

Classifying claims could be one of the effective ways to leave room for different treatment among creditors in light of specific circumstances. The framework for classification should generally be flexible, but the issue will finally depend on the judgment about how broad the scope of debt for the SDRM should be.

Domestic debt could be excluded from the SDRM, in view of the less severe nature of collective action problems and the legal instruments available for sovereigns to address the holdout problem. However, further examination would be necessary on the feasibility of this approach.

We should note that official bilateral claims are substantially different in characteristics from private claims. We recognize some merit in including claims of Paris Club official creditors into the scope of the SDRM, but its implications on the function of the Paris Club to compile restructuring proposals rapidly should further be analysed.

The selection procedure for members of the SDDRF should be arranged so that transparency, accountability and independence of the SDDRF are ensured.

We welcome the staff's examination on the issue of the scope of debt and the powers and composition of the Sovereign Debt Dispute Resolution Forum (SDDRF), based on the work program that was presented at the previous Board meeting on sovereign debt restructuring mechanism (SDRM) last March.

As the staff paper points out, the SDRM, unlike the contractual approach, has the potential to deal with collective action problems and to restructure debts within its scope under stipulated procedures comprehensively and simultaneously, thereby contributing to the orderly implementation of sovereign debt restructuring. Therefore, on the one hand, we understand the idea that the scope of debt for the SDRM should be as broad as possible, while taking into account the characteristics of each debt. On the other hand, incorporating a wide range of debt into the SDRM could also have disadvantages in that it would be necessary to establish a framework, such as complex classification. This would differentiate the treatment among creditors to ensure substantial intercreditor equity, because the degree of difficulty in resolving collective action problems differs according to the types of claims, the number and characteristics of creditors, and the governing law and jurisdiction. In examining the scope of debt for the SDRM, we should be realistic and have a balanced view on these advantages and disadvantages.

Classifying Claims

The staff paper is appropriate in examining the idea of classifying claims, drawing upon practices that have been developed in nonsovereign insolvency laws. This chair also thinks that classification could be one of the effective ways to leave room for different treatment among creditors in light of specific circumstances.

As for a possible framework for classifying claims, the second approach, which is more flexible than the first one, would be appropriate generally, taking into account the diversity of sovereign debt. The more comprehensive the scope of the SDRM becomes, the more difficult would be for the first approach to be made operational. However, this issue will finally depend on the judgment about how broad the scope of debt for the SDRM should be. If we substantially restrict the coverage of the SDRM, the first approach could be rather desirable, as it provides greater clarity and predictability. The possibility of disputes would also be reduced and the function of the SDDRF would be limited accordingly.

Domestic Debt

The discussion on sovereign debt restructuring has attracted attention following the changes in the composition of international capital flows in which bonds replaced syndicated bank loans as the primary vehicle for financing sovereigns, and collective action problems were found to be serious in debt restructuring of bonds not governed by domestic law (or subject to domestic courts). In this sense, staff's approach, which distinguishes "domestic" from "external" debt by governing law (and jurisdiction) in the consideration of the SDRM, is appropriate.

Based on this approach, staff points out that domestic debt could be excluded from the SDRM for the following reasons: first, collective action problems are less severe in the case of domestic debt than in external debt; second, sovereigns can address the holdout problem by putting in place legal instruments; and third, external creditors could carry out their own negotiations with a view to ensuring intercreditor equity even when domestic debt is excluded from the SDRM. This chair thinks, however, that it would be necessary to further examine the feasibility of this approach by reviewing the experience of such frameworks in previous debt crises.

Official Bilateral Debt

Official claims are provided from the resources borne by taxpayers of creditor countries, and include those that arise from assistance provided from the non-commercial points of view, such as development assistance and promotion of trade. In this sense, we should note that those claims are substantially different in characteristics from private claims.

If official bilateral claims are to be included in the SDRM as a separate class and if the SDRM is to involve non-Paris Club creditor countries and private creditors into a comprehensive debt restructuring framework, such a framework could become a useful tool for the comprehensive resolution of debt problems, as restructuring processes could be promoted by giving each class of creditors a formal veto over the restructuring proposals. However, including claims of Paris Club official creditors into the scope of the SDRM could also have disadvantages. That is, that sort of arrangement could impair the function of the Paris Club in which homogeneous members have been able to compile restructuring proposals rapidly, based on established rules but with sufficient flexibility. We would appreciate further analysis and consideration by staff on this point.

In implementing the SDRM and thereby achieving the objective of comprehensive debt restructuring, it is critical to ensure the involvement of non- (Paris) Club official bilateral creditors as well as private creditors in order to ensure intercreditor equity. Further concrete examination will be needed on issues like what sort of amendments to the Articles of Agreement and/or a new treaty, and corresponding domestic legislation will be necessary, as well as the costs and feasibility of implementing them.

SDDRF

This chair believes staff's proposals on the powers and composition of the SDDRF are generally appropriate. I will make a few brief comments on the proposed procedures for selecting members of the SDDRF. First, staff envisages the number of members of the independent committee of eminent persons to be established by the Executive Board as being 10-11. Although staff has mentioned this number as an example, the procedure for selecting 10-11 (qualified) people could itself be an issue. A simple and clear-cut means might be selecting one person per constituency. Second, when the committee of eminent persons recommends, say, 21 persons from the list of nominees (that could amount to 184 names), it should thoroughly explain to the Board of Governors why it believes these 21 persons are well qualified, with a view to ensuring transparency and accountability. Third and finally, arrangements could be made so that the members cannot be impeached except under exceptional circumstances, in order to ensure the independence of the SDDRF from the Board of Governors, the Executive Board and the Management of the Fund.

Mr. Low and Ms. Phang submitted the following statement:

Introduction

This paper presents some of the design features of the SDRM and discusses the scope of debt to be covered as well as the operational modalities of the dispute resolution forum. While the staff has provided useful options, these are not straightforward issues and we believe that much more analysis and consultation with both creditors and debtors would be needed. Nevertheless, we think that we are making promising progress and if the SDRM can indeed be designed to provide a more orderly, predictable and speedy debt restructuring process, it will be an essential tool in the new international financial architecture to complement current market driven mechanisms for sovereign borrowers to restructure their unsustainable debt. However, since circumstances vary amongst countries, flexibility in the inclusion of design elements is of utmost importance to allow for diversity and to avoid a one-size-fits-all approach.

SDRM: More rapid, orderly and predictable debt restructuring process?

Staff have correctly pointed out that the key challenge of the SDRM is to have a mechanism that will resolve collective action problems and encourage the debtor and its creditors to reach a speedy agreement on a restructuring that will minimize economic dislocation and facilitate a return to medium-term viability. The basic premise of the SDRM is that the sovereign debtor would have the exclusive authority to decide whether and when to activate the SDRM. We support this premise for reasons elaborated by Mr. Padoan and Mr. Bossone. In addition, as staff pointed out, a central feature of the SDRM would be the ability to bind all creditors to a restructuring agreement that has been accepted by a qualified majority. However, we have some comments and questions on the features enumerated by staff in paragraphs 9 and 11 of the paper:

Stay on creditor enforcement: Staff proposed that the SDRM would provide the debtor with temporary legal protection from creditor litigation after a suspension of payments, as long as the debtor obtained the agreement of a super-majority of creditors. We wonder if the qualification is meaningful. Once the debtor decides to restructure its debt and activates the SDRM, it should automatically be given legal protection against creditor litigation. Otherwise, hold-out creditors could be initiating legal action against the debtor while the debtor tries to obtain the agreement of a super-majority of creditors.

Protection of creditor interests: Staff appear to have assumed that the debtor would have to enter into a Fund-supported program in order to activate the SDRM as a means of providing creditors with assurances that the debtor is implementing appropriate economic policies. This may be at odds with the principle that the debtor should have the exclusive right to decide whether to activate the SDRM. While it may not be the norm, there may still be instances where the debtor decides to implement corrective measures on its own without seeking Fund financing and being subject to Fund conditionality. We believe that debtors should not be precluded from activating the SDRM to restructure their debts even if they do not wish to obtain Fund financing. In any case, it should ultimately be left to the creditors to judge whether the debtor is taking appropriate economic policies that will provide the creditors with sufficient assurances that they would be able to recover their investments in due course.

In paragraph 11, staff stated that "the official community through an amendment of the Fund's Articles and, where necessary, changes to domestic legislation would provide the statutory legal basis to make this (restructuring) agreement binding on all relevant creditors." We would appreciate staff's clarification whether the SDRM would be effective and binding on Fund members only after each and every country have made changes to their domestic legislation, where necessary. We believe that this should be the case to avoid any loopholes in the event that domestic legislation could not be passed in any specific country.

Creating Creditor Classes to Provide Balance between Breadth and Flexibility

We agree that the scope of sovereign debt to be covered by the restructuring under the SDRM would need to be comprehensive, but at the same time there should be enough flexibility to allow the debtor to exclude certain categories depending on its specific circumstances. However, it is not easy to achieve the right balance between ensuring intercreditor equity and flexibility. Staff has proposed to classify creditors into different classes, to ensure that sufficient amount of debt is covered in the interest of restoring sustainability and to achieve sufficient intercreditor equity to garner adequate support. However, while this seems to be a sensible approach, there are potential risks as well. As noted by staff, since all classes of creditors would be required to approve the overall restructuring, this would provide each creditor class an effective veto power over the terms offered to other classes. Depending on how each creditor class is defined, this could delay or even prevent a restructuring under the SDRM. For example, if creditors are classified as secured and unsecured creditors, secured creditors could prevent a restructuring if they believe that they would be in a better position to recover their investment through enforcement of their security than through a restructuring. On the other hand, it may not be fulfilling the objective of achieving intercreditor equity if secured creditors are grouped together with unsecured creditors because the strength of their claims on the debtor is different. While this may be a simplistic example, we believe that much more thought needs to be given into how to classify the creditors.

Notwithstanding the above, we are more in favor of the second approach to classification of creditors whereby certain classes of debt would be pre-specified in the text of the treaty, while allowing for the creation of additional classes in individual cases. In view of the evolving nature of capital markets and instruments, a flexible approach towards creditor classification would be more appropriate. In addition, the option of the incorporation of additional classes will allow the debtor to increase the scope of the debt to be restructured in the event that restructuring of the pre-specified scope of debt is not sufficient for a return to sustainable development. However, there could also be the risk that this would impede the speed of the restructuring process in the sense that garnering the approval of a qualified majority of creditors on the restructuring terms from each creditor class may involve an unduly long process and require arbitration by an impartial entity to ensure equitable restructuring terms.

Domestic Debt

We concur with staff that in the context of debt restructuring, it is better to define domestic debt according to the governing law and the jurisdiction of the claim since the main problem is the likelihood of the restructuring being undermined by collective action problems. The second approach of excluding domestic debt from the SDRM is preferred since in most cases, the sovereign debtor has the legal instruments to deal with any possible hold-out problems.

Official Bilateral Claims

We concur with staff that the assessment of intercreditor equity between private creditors and official bilateral claims is complex and the decision of whether to include them as a separate class in the SDRM or to exclude them will have to be determined on a case-by-case basis. While including Paris Club claims in the SDRM would largely satisfy the need to ensure intercreditor equity, there are potential risks as private creditors could effectively prevent a restructuring of official bilateral debt by the Paris Club even if the Paris Club, being sovereign lenders, are prepared to restructure their debts on highly concessional terms in order to assist another sovereign and avoid contagion in the interest of the global financial community. In any event, we believe that since the Paris Club already has a well-coordinated mechanism for restructuring of sovereign debts, the approach adopted will have to be a sequenced one regardless of whether official bilateral claims are included or excluded from the SDRM.

Sovereign Debt Dispute Resolution Forum

We concur with the main features of the SDDRF but we would like to seek clarification on some of those features. We agree with limiting the powers of the SDDRF to administering claims and resolving disputes between creditors and between the debtor and creditors. Staff emphasized that the SDDRF would not be able to challenge decisions made by the Executive Board of the IMF nor would it be involved in the application of the SDRM provisions. We also agree that the SDDRF should not only operate independently, but be perceived to operate independently from the Executive Board, the Board of Governors, and the Management and staff of the Fund.

We agree with the first step whereby each of the 184 members nominates one candidate for the pool from which the final members of the SDDRF would be drawn. We also agree that the selection of candidates should be guided by the four principles of independence, competence, diversity and impartiality and should not be confined to being a national of the nominating country. However, it is not clear to us how the 10–11 members of the independent and qualified committee of eminent persons would be selected. As this Committee is going to be established by the Executive Board, what would be the procedures to ensure that the Committee members would not only operate independently but be perceived to operate independently of the Executive Board? Having all 184 members nominate a candidate to the pool would not ensure independence of the SDDRF if the Committee that selects the 21 names from the pool is not seen to be independent. In particular, if the selection of the Committee by the Executive Board is by a simple majority of votes, then there could be accusations that the Committee is biased towards the developed countries. We would think that the appointment of the Committee as well as the final composition of the 21 member SDDRF panel be appointed by a 70 percent super-majority of votes of the Executive Board and the Board of Governors, respectively, or alternatively by a simple majority where each Fund member has one vote.

As for the final step when three members are impaneled by the presiding member of the SDDRF, the panel members should be endorsed by the sovereign debtor as well as the committee representing the creditors to ensure their acceptability by both the debtor and the creditors, thereby enhancing the legitimacy of the panel's decisions. However, it is not clear whether in staff's proposal, the presiding member would also be a member of the panel and if so, whether he would have a vote in the decision making. We would expect that the presiding member would not be a member of the decision making panel so that there would not be a possibility for a split decision.

These are questions for which we hope staff can provide some clarification.

Conclusion

The rationale for pursuing the SDRM is to provide a framework for a sovereign debtor with unsustainable debts to approach its creditors promptly to restructure its debts, and preferably before interrupting debt-service payments. If the SDRM could indeed provide the incentive to help overcome the reluctance of sovereign debtors to seek a debt restructuring, then this would be a major complement to our efforts to enhance the international financial architecture. However, questions still remain whether the lack of a predictable legal mechanism is the single most important reason for the reluctance of sovereign debtors to seek a debt restructuring. Mr. Portugal has raised many interesting questions in his preliminary statement and we look forward to hearing staff's responses. In particular, we support his suggestion that we seek the views of emerging market sovereign debtors on the usefulness of a SDRM-like mechanism.

Mr. Cippà submitted the following statement:

Key Points

I strongly support the creation of an SDRM. The staff paper makes an important contribution in clarifying key operational issues.

The SDRM framework should be as broad and comprehensive as possible.

In principle, the SDRM should include all categories of debt. Both, domestic as well as official bilateral debt should be incorporated.

The general framework should specify some creditor classes that identify distinctly different types of claims.

On a case-by-case basis it should be possible to create further classes of creditors, based on the claims recorded in the debt book.

A future paper should analyze the composition of sovereign debt in and across countries and its evolution.

Introduction

I thank staff for the detailed paper setting out the next steps in our endeavor to create a Sovereign Debt Restructuring Mechanism (SDRM). Although the degree of technicality is at times daunting, the scope of the exercise and the complexity of the issues necessitate the detailed discussion of the legal and economic consequences of the SDRM's operational set up.

I continue to strongly support the creation of an SDRM, which, ideally will never have to be activated. Unsustainable debt profiles can represent a key vulnerability for members, as recent experience has shown. An SDRM will provide a framework for the orderly, timely and predictable resolution in the exceptional cases, in which debt restructurings are necessary. To ensure inter-creditor equity, the SDRM should allow for the inclusion of all debt categories. At the same time, different creditor types might need to be treated differently to take into account previously established legal rights. Such differential treatment should be founded on clear principles.

Merits of Creating Creditor Classes

The need for an SDRM arises from the fact that sovereigns' debts are held by very different types of creditors. Negotiating a restructuring deal among heterogeneous creditors necessitates some classification of different creditor types. As noted by staff, some creditor classes can always be identified from the outset, such as general type (private vs. official) and claims of different seniority (secured vs. unsecured). Others cannot be identified a priori for all countries, firstly, because of the large differences in countries' debt composition and, secondly, because of the evolutionary potential of capital markets.

The diversity of debt situations and the inventiveness of markets precludes the general framework from foreseeing a full classification of creditor classes. It can, however, identify some creditor types that make up a distinctive class. Some further classification should be foreseen on a case-by-case basis once all claims have been registered in the debt book. The procedures for the latter should be clearly delineated in the framework and they might be subject to creditor approval concurrently to the acceptance of the stay.

One consequence of the creation of classes is the mutual veto power. A small minority may thus block a decision and with it the whole process. We would have to decide, if the creditor class would need to represent at least a minimal critical portion of debt, which would need to be in relation to the number and types of creditor classes.

Furthermore, if only a few creditor classes are identified in the framework, clear rules must guide the creation of further creditor classes. In order to get a picture of what this might entail, it would be helpful to get insights into the composition of debt in and across countries. Additionally, it would be interesting how this composition has evolved over time, i.e. debt issuance (type of debt and prices), debt instrument innovation, debt management and incentives for strategic debt swaps, and secondary debt markets

Distinguishing between External and Domestic Debt

The definition of domestic debt proposed by the staff appears to be the most reasonable way to classify domestic debt.

Ideally, an SDRM would not need to discriminate between domestic and external debt because the two debts are, in fact, indistinguishable—aside from the jurisdiction of issuance. In the event of a default, there should be no a priori reasons for differential treatment based on jurisdiction. Any classification of creditors would be based on other creditor characteristics.

In reality, however, in most countries domestic debt is distinctly different from external debt. The extent and types of differences vary tremendously from country to country. Staff presents two main arguments for a segregation of domestic and external debt.

First, the impact of a domestic restructuring can be detrimental to the economy, justifying a restructuring on distinctly different terms. Second, domestic debt is, by definition, governed by the laws and courts of the sovereign and thus subject to its influence. The collective action problem can be solved by other means.

In my view, these arguments need some qualification. Sovereigns or institutions under their influence commonly hold a mix of domestic and external debt. The holdings of the latter may be sufficiently large to attain a critical influence whereby a sovereign can manipulate debt. The SDRM-framework must include safeguards against such manipulation through the sovereign. One can argue that the relevant provisions for exclusion would be easier to establish and enforce if the SDRM included domestic as well external debt.

I also feel uneasy with a general treatment of domestic debt as claims that are subject to unreliable laws—laws that can be amended to prevent the creditor from obtaining a judgment on its original claim. As long as we expect sovereigns to amend their laws, this is likely to be self-fulfilling. Excluding domestic debt from the SDRM might fuel such a prophecy. In subjecting domestic debt to the SDRM we are more likely to enhance a convergence of the characteristics of domestic debt to those of external debt.

In a similar vein, excluding domestic debt from the SDRM might create unhealthy incentives in the domestic banking sector to hold domestic debt.

Finally, it may also be possible that domestic debt is widely held by foreigners. In this case the inclusion of domestic debt in the SDRM would seem advantageous as well. In view of these remarks, I favor including domestic debt as a separate class in the SDRM.

Framework for Restructuring Official Bilateral Claims

Official bilateral debt is a clearly defined creditor class that is already subject to a functioning restructuring mechanism. The potential for strategic adaptation or innovation on the part of this creditor type is clearly limited. Essentially I would expect the two propositions—making official bilateral debt a separate creditor class or excluding it entirely from the SDRM—to achieve a very similar results.

The Paris Club procedures are not, in general, laid out for the treatment of all debt as foreseen under the SDRM. It would be interesting to hear from the Paris Club how the procedures might fit into an SDRM or work in parallel. In view of the goal of inter-creditor equity and the achievement of comparable results, I am biased towards an inclusion of the Paris Club in the SDRM.

Sovereign Debt Dispute Resolution Forum (SDDRF)

At this state of the discussion, I find the process of selection and appointment acceptable. Most of the powers of the SDDRF will crystallize as the SDRM takes shape. If, for example, further creditor classes are to be formed based on the claims in the debt book, it will be important to work out procedures and powers for the SDDRF accordingly. Above all, the framework must assure that the SDDRF's decision-making process is credible and independent—and perceived as such.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to questions from Directors, pointed out that the mechanism remained a work in progress, and that the staff paper proposed different possible approaches for three particular issues. On the issue of Paris Club debt, such debt could either be integrated in the proposed framework or the Paris Club could be left to operate in parallel with the new mechanism. Some discussions had already been held with the Paris Club Secretariat, and the staff would seek further reactions from Paris Club members and private market participants as the options presented in the staff paper were further refined. At some point, it would be the Paris

Club that would have to take a final decision on whether to include bilateral official credit in the SDRM. The creation of the new framework would probably require some procedural changes in the Club's operations in either case, although they would obviously be more significant if official claims were to be included in the SDRM.

Regarding Mr. Shaalan's question as to how non-Paris Club official bilateral creditors would be represented in the mechanism, the Deputy Director explained that all official bilateral creditors would be included in a creditor class if such debt were to be included in the mechanism. Debtors would have to negotiate debt restructurings both with Paris Club and non-Paris Club creditors, and the ratification of a deal under the mechanism would depend on its acceptability to members of the group of official creditors holding the percentage of claims required under the mechanism.

To conclude, the Deputy Director assured Directors that their requests for a more structured outreach to markets and debtor countries in the process of designing the SDRM would be adequately pursued.

Mr. Portugal asked if the staff envisaged Paris Club and non-Paris Club official bilateral creditors receiving the same treatment under the new framework. In addition, he noted that the arguments used by the staff to propose the exclusion of Paris Club members from the framework could also apply to other external private creditors like commercial banks, as the same kind of collective action problems that applied to bondholders did not arise in the case of bank lending, and alternative mechanisms to restructure this debt had worked reasonably well in the past.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) answered that the intention would be to treat Paris Club and non-Paris Club creditors equally under the mechanism. Regarding the inclusion of bank lending under the framework, reasons of equity and acceptability of restructurings to all private creditors justified the need to make such restructurings as comprehensive as possible among private creditors. In addition, those claims were governed by foreign law, and the legal framework in which they were enforced was different from that of Paris Club debt.

Mr. Portugal observed that Paris Club debt was also governed by foreign law from the point of view of the debtor.

Mr. Duquesne informed Directors, on behalf of the secretariat of the Paris Club, that no formal position had yet been reached among its members as to whether their official bilateral debt should be excluded or included in the SDRM.

The staff representative from the Legal Department (Mr. Hagan) confirmed that the critical criterion for determining whether a claim should be included within the SDRM would be the law governing the claim. However, in the case of Paris Club debt, official creditors had not historically sought to enforce their claims through litigation when negotiating debt restructurings. In addition, while commercial banks had generally exercised forbearance in terms of legal enforcement during the 1980s debt crisis, it would be premature to decide to exclude their loans from the framework given the growing securitization of commercial bank loans. Indeed, some of the most active litigation by vulture funds had resulted from the acquisition in secondary market of commercial bank claims.

The staff representative from the International Capital Markets Department (Mr. Fisher), in response to questions from Directors, made the following statement:

> A number of Directors raised a few questions about the treatment of domestic debt. Mr. Portugal asked why the staff believes that creditors holding claims governed by foreign law are likely to insist, as a condition for restructuring their own debt, that domestic debt be included in the restructuring. There are two issues here, one being the magnitude of the debt adjustment required in order to bring the country to sustainability, and the second one being intercreditor equity. It is unlikely that foreign creditors will agree to restructure their own claims unless it is in the context of a comprehensive package—both in terms of treatment of debt and in terms of adequate policies—that offers the assurance that debt will be sustainable and that restructured claims will be repaid.
>
> Regarding intercreditor equity, while there are no directly applicable precedents, we have two indirect indicators of the importance attached to it in the market. When Ecuador initially approached its creditors with a request for restructuring, which was limited to Brady bonds, the feedback received from investors was that they would insist on the inclusion of eurobonds as a condition for restructuring Brady bonds. While this case refers to different international instruments, recent contacts with different types of investors in Europe and the United States indicate that they would also insist on the inclusion of domestic debt in cases where this is a significant part of total debt.
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> Mr. Portugal has also asked whether we can provide empirical evidence of the magnitude and nature of the problems that the SDRM is attempting to solve. While this is difficult given the speculative nature of some of the problems that we are trying to solve, it would certainly be possible to examine the case of Russia, where the disappointing results of the offer launched by the authorities in May and June of 1998 to exchange GKOs and OFCs for eurobonds was interpreted as reflecting a collective action problem.
>
> Finally, Mr. Zoccali noted that further work is needed on the nature and dynamics of regaining access to voluntary market financing after crises. The International Capital Markets Department is currently working on this, and will in due course bring this paper for Board consideration.

Mr. Portugal suggested extending the analysis of empirical evidence on collective action problems in debt restructurings beyond the case of Russia. Regarding the exclusion or inclusion of domestic debt in the framework, he observed that the real issue was not whether domestic public debt would need to be restructured in some cases, but whether these restructurings should be done through the proposed framework. When needed, it would be preferable to undertake these restructurings outside the framework, as had been the case in the past. External private creditors appeared to agree with this approach, as indicated in the staff paper.

The staff representative from the Legal Department (Mr. Hagan), in response to questions from Directors, made the following statement:

> Many questions have raised questions on legal, institutional, and design aspects of the SDRM. Mr. Low asked whether there would be any automaticity with respect to implementation of the stay on litigation by creditors once the SDRM is activated. The principle would be that a qualified majority of creditors and the debtor should make all of the key decisions on restructuring terms, seniority of new credit, and on the activation of the stay. The problem is that it is unlikely that creditors will be sufficiently organized during the initial 90-day period after the activation of the SDRM, and until a verification of claims can be completed to enable them to take such a vote. Three different options have been identified to address the issue of protection from litigation during this period: no stay, a unilateral stay by the member country that would expire after 90 days, and a stay endorsed by the Fund for the first 90 days. Clearly, there are advantages and disadvantages to each of these options. The private sector has made it clear that they strongly believe that there should be no stay for the first 90 days. The question is whether this option would impair the effectiveness of the mechanism, and in this regard, it would be important to recognize that even if the stay on litigation was delayed for 90 days, it would still be possible for the authorities to impose controls on capital outflows immediately. The staff will continue analyzing these different alternatives as we go forward in the design of the SDRM.
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> In terms of the coverage of the SDRM, Directors have acknowledged the fact that not all creditors are similarly situated, and they have raised a number of general questions about the different techniques that the staff has identified to achieve a comprehensive framework. Creditor classification is one option to strike an adequate balance between these needs. While recognizing the benefits of this approach, a number of Directors have asked whether we could be creating a new collective action problem by creating creditor classes that can have a veto over the terms of the overall restructuring, as this could merely result in the substitution of holdout classes for holdout bondholders. However, analyzing the motivations for the creation of creditor classes should provide some assurances to Directors that these concerns should not pose a significant risk to the framework.
>
> One aim of creditor classes is to protect the seniority of claims. If the claims of secured and unsecured creditors are mixed for voting purposes, there

is a possibility that a majority of unsecured creditors will strip the collateral from secured creditors through unfair means. These different kinds of creditors should be separated for inter-creditor equity reasons. Secured creditors would receive more leverage under this approach, but they deserve it because they have bargained for enforcement through collateral. If that were not the case, the value of security would be undermined, with adverse consequences on borrowers. In addition, these types of classes should be very limited, and they will be prespecified in the amendment.

Another aim of distinguishing between classes is to provide a mechanism whereby a restructuring is facilitated by offering different restructuring terms to different groups based on their preferences. For example, domestic banks may be more willing to take nonnegotiable loans, and creditor classification provides a basis for making these distinctions in restructuring terms. These types of classes would perhaps not be prespecified, and they could be created on a case-by-case basis at the initiative of the debtor. Therefore, it is unlikely that a debtor would be proposing classes that could increase the holdout problem.

The second technique identified in the staff paper to address the issue of different kinds of creditors is exclusion from the framework. Directors have asked whether it would be possible to establish a legal mechanism whereby domestic debt, for example, would be excluded under the terms of the amendment, with the possibility of revisiting its inclusion in the future based on experience with implementing the framework. The implied question is whether this could be done in such a way that it would not be necessary to make additional amendments that would require approval by national legislatures. The answer is that there is probably a legal mechanism, and that there is already a precedent for this. The Articles of Agreement provide that the Board of Governors may establish a new organ of the Fund, the Council, by an 85 percent majority. Similarly, one could imagine that under the amendment, the legislatures of member countries could empower the Board of Governors to include domestic debt or Paris Club debt in the SDRM by an 85 percent majority. Clearly, it is a decision that the legislatures would have to take, but there is a precedent which may be relevant.

Regarding domestic debt, Mr. Wijnholds has asked whether or not there is any precedent for a sovereign country having effectively restructured its domestic debt through domestic legislation. Perhaps the most notable precedent is the legislation introduced by the United States and a number of western European countries in the 1920s and 1930s abrogating the gold clause, which was a commitment to repay either in gold or currency based on a certain weight of gold. Because of the depreciation of currencies, many countries, including the United States, abrogated that commitment. That was an effective restructuring, which was held in many countries to be constitutional. Therefore, this is possible in legal terms, although the policy question remains as to whether the Fund should be encouraging countries to do this.

Regarding the questions raised on the Sovereign Debt Dispute Resolution Forum (SDDRF), I would like to provide some reassurance to Directors. First, the specific proposal in the staff paper was merely designed to initiate the discussion, and it is very preliminary. We will have to return to a number of difficult questions, and Directors have already identified areas where we need to do further thinking. Second, Directors should be reassured that the staff has not been entirely original in its thinking on this issue, as it has consulted broadly with a number of key interested parties, academics, judges, professional organizations, including NGOs. The staff has also tried to draw on precedents in international organizations.

Turning to specific questions on the proposed power of the SDDRF, Mr. Portugal has asked whether or not we are creating the potential for an active and intrusive forum that could have strong investigative powers and give rise to sovereignty concerns. That was not the intention at all. In fact, because it is a dispute resolution forum, it means that the forum would not on its own initiative investigate whether or not a claim is fictitious. Rather, it would rule on allegations brought by the parties, and based on evidence provided by the parties. In other words, it would play a passive, rather than an active role in the process.

While many Directors are supportive of the establishment of an SDDRF, there are concerns as to whether this should be done through an amendment of the Articles of Agreement, whether this organ should be established within the Fund, and whether it would be—and be perceived as being—independent from the Executive Board and the Board of Governors. The procedure that the staff has tried to come up with to address these issues is not entirely novel. The most notable example is the International Court of Justice, which is an organ of the United Nations. Its judges are appointed through an election process by the General Assembly and the Security Council. My understanding is that there is not a perception that the integrity and the independence of those judges is compromised by this election process. Therefore, the concept presented in the staff report is reasonable. The question is what specific procedures should be followed for the election of SDDRF members.

The procedures identified in the staff paper for the election of SDDRF members are very preliminary, but the staff considers that they address the concerns that the independence of the organ should not be compromised. First, perspective judges would be nominated by Fund members, not by the Executive Board or the Board of Governors. Second, the Articles of Agreement would specify strict qualification requirements, both with respect to expertise, number of years sitting on the bench, and also moral character.

Third, the eventual pool selected would be instituted through a procedure that could be vetted by professional bodies. Finally, the impaneling would only take place when a case actually arose, and that would be done by the presiding judge, not by decision of the Executive Board. Until that time, essentially, the judges would be working in their own capitals, and they would not be perceived to be employees of the Fund.

One set of issues that Directors are concerned about is that the proposed procedures could tilt the balance too far to the creditors' side, given the fact that the Executive Board will be nominating the committee of wise persons that will be selecting the judges, and given the fact that the voting power of the Executive Board is weighted. This is an important question that can be addressed in certain ways. One possibility is to have a qualified majority to give developing countries a sense that they have some form of veto. Another is to have an organization like the International Court of Justice play an advisory role in that process.

Finally, the question arose as to whether countries would need to adopt domestic legislation in order for this treaty to be effective. It depends on the constitution of the country. Under some countries' constitutions, the acceptance of the Fund's amendment means that it becomes a part of domestic law. In other countries, such as the United States, domestic legislation would need to be adopted, as has been the case in previous amendments.

Mr. Portugal reiterated his doubts as to how the SDDRF could make judgments on whether a particular sovereign was exercising undue influence on some creditors to accept certain measures. The enquiry into the motives of sovereigns and creditors that would be required to establish that there had been a case of collusion between certain creditors and the sovereign debtor would face obstacles under certain legal systems which do not accept inquiries into the actions and motives of sovereigns. Another contentious issue related to the establishment of an SDDRF would be the intended objective of achieving uniformity of interpretation, as it remained to be seen whose interpretation would prevail in case of different interpretations of the same domestic law governing bond contracts by domestic tribunals and by this international body. Finally, the proposal to make decisions of the SDDRF final, in the sense that they could not be challenged by domestic judicial courts, might not be feasible in countries with constitutions that did not allow exclusion from judicial oversight of any sort of decision. The creation of an SDDRF would require constitutional amendments in those countries.

The staff representative from the Legal Department (Mr. Hagan) replied that under the approach proposed in the staff paper, creditors could take the initiative to present allegations of undue influence by the sovereign in the voting process. The more detailed rules of procedure and evidentiary rules that would arise in that context had yet to be worked out as part of the process toward designing the SDRM framework. On the issue of the SDDRF having jurisdiction over cases governed by different domestic laws, it should be noted that the separation between substantive law and jurisdiction would not be a novel development in international law. Many contracts currently allowed a court in the United Kingdom, for example, to entertain cases of contracts governed by New York law, and qualified judges would certainly take cognizance of substantive law, as well as established practice, in the relevant jurisdiction. Therefore, private creditors should be relatively familiar with this approach, and they would probably not be opposed to it as long as they had confidence in the quality of the judges. Finally, on the possible constitutional issues surrounding SDDRF rulings, while the staff would need to investigate this issue further, its current understanding was that the constitutional requirements in some countries referred to the need for judicial intervention as a matter of due process, but there was no specification that the court be necessarily located within that particular jurisdiction.

Mr. Kiekens made the following statement:

At its last meeting, the International Monetary and Financial Committee (IMFC) asked the Fund to continue working on both a contractual approach to sovereign debt restructuring, and on a statutory sovereign debt restructuring mechanism (SDRM), since these are considered complementary. The Board has already discussed several issues related to the contractual approach. Today's staff paper (EBS/02/151) focuses on how to make the statutory approach operational.

Even though such fundamental questions as political support for the SDRM have not yet been settled, it is important to discuss the technical questions now. Such issues as what kinds of debt should be covered, the treatment of non-sovereign debt, the role of exchange rate controls, the standings of senior private financing and financing from preferred creditors after debt rescheduling—need to be addressed before we can have a clear picture of the restructuring mechanism to be established. Clarifying the technical issues will help foster political consensus.

I therefore welcome the staff's excellent preparation for today's Board discussion. I particularly would like to thank Mrs. Krueger, who has energetically continued to refine and explain her innovative proposal during many speeches and articles delivered all over the world since last November 26.

Today's Board discussion complements work now going forward in several international forums on the two approaches to debt restructuring. These approaches are inextricably linked. Questions such as scope of the debt to be covered must be addressed for both the contractual and statutory approaches.

The overarching principle in restructuring a country's unsustainable debt must be fair and equitable treatment of all creditors. In judging what is fair and equitable, the economic reality should be duly considered. The currency in which the claims are expressed is probably economically the most relevant distinction among creditors. The most common form of sovereign default—at least in the economic sense—is currency debasement, either directly through devaluation or indirectly through inflation. Creditors in foreign currencies are protected against these kinds of risk. It would be a serious mistake to conclude that equal treatment implies than any reduction in the nominal net present value of the foreign debt must be matched by a similar reduction in the nominal net present value of the domestic debt. Mr. Portugal rightly points out that domestic creditors may already have incurred severe crisis-related costs, such as devaluation and unexpectedly high inflation that is not compensated by adequate interests. Moreover, what often makes a country's debt unsustainable is the explosion of its foreign currency component in terms of GDP, triggered by a currency crisis. Also, restructuring a country's domestic debt may wipe out its banking system and seriously damage its debt servicing capacity. Therefore, from an economic standpoint, comparable treatment between domestic and foreign creditors requires a considerable element of judgment. Including a country's domestic debt in the SDRM would make it especial difficult to arrive at a balanced judgment by calling the many domestic debt holders to express their views on how their country's Treasury should default on its financial relations with its citizens. Politically this is unrealistic.

From a legal viewpoint, the most relevant criterion for categorizing creditors to arrive at an orderly debt restructuring is obviously the applicable law. Debt governed by domestic law can be restructured by unilateral decision of the sovereign, and in principle there are no collective action problems. However, the restructuring of claims governed by foreign law requires either the consent of every creditor or a binding, authoritative decision by a majority of creditors on the basis of an international law that establishes an SDRM.

This brings me to the scope of the debt to be covered by the SDRM. I prefer a restrictive approach. The SDRM should only be used where there is a problem to be solved. It should not replace well functioning debt restructuring procedures already in use. As I have pointed out, sovereign debt governed by domestic law can be restructured by act of the sovereign, for instance by amending national legislation. This permits avoiding collective action problems between holders of domestic debt. Conversely, including domestic debt under the SDRM would make its restructuring more burdensome for the sovereign.

The claims of most official bilateral creditors have been rescheduled successfully under the auspices of the Paris Club. No serious problems of collective action have emerged. The Paris Club itself is functioning well. Its practices have been kept current with developments in the international financial system, enabling its members to respond flexibly to debtors' external financing needs. Including this well-functioning framework under the SDRM would risk impairing its efficiency. The usefulness of including the Paris Club should be considered again when we have accumulated some experience with an SDRM limited to foreign private creditors.

Overextension of the SDRM at the outset could reduce political support for launching such a mechanism. Debtor countries might consider the inclusion of domestic debt under the SDRM to imply an unacceptable loss of sovereignty. Likewise, official creditors could consider including their claim under the SDRM as an equally unacceptable loss of their sovereignty.

The staff paper sees advantage in excluding official bilateral claims from the SDRM, because Paris Club approval would not be required for the restructuring of private creditors' claims. This could be an advantage, and I quote from the staff paper, "when the official sector was not willing to restructure, e.g., because of the absence of a Fund arrangement" (p. 21). However, this argument is at odds with an essential feature of the SDRM. A finding that "the debtor was implementing a Fund-supported program or was working closely with the Fund to elaborate policies that could be supported with the use of Fund resources" was presented as an essential feature of an SDRM to give creditors assurances that their debtor is adopting and implementing appropriate policies that preserve asset values.

I conclude, in line with an emerging consensus in the Board, that we should have three distinct restructuring mechanisms: an SDRM for private external debt, or more precisely debt governed by foreign law; the Paris Club, for bilateral external debt to official creditors; and a unilateral decision by the sovereign for its domestic debt, more precisely the debt government by is domestic law. How do we assure consistency among the outcomes of these three distinct procedures is an issue calling for further research and negotiation. This will involve establishing broad principles that should guide the restructuring of countries' domestic debt. At this early stage I would like to point out two such principles: proportionality, which requires that unilateral restructuring decisions should be limited to the minimum needed to restore debt sustainability; and comparability, which requires that the economic burden does not fall more heavily on domestic creditors than on foreign creditors. I have already pointed out that this requires a considerable element of judgment. We must find ways to exercise international surveillance on sovereigns' adherence to these principles as they unilaterally restructure their domestic debt.

I broadly agree with the staff's proposals for a Sovereign Debt Dispute Resolution Forum (SDDRF). Its legal powers should be clearly defined and limited to the administration of claims and settlement of disputes related to the decision making of creditors under the SDRM. The forum should be independent of the Fund's staff, Management, Board, and member countries. It should be impartial with respect to the debtor countries and their private creditors. I am confident that it is possible to find and appoint judges that satisfy these criteria. The Court of International Justice and the Dispute Resolution Panel of the WTO are good examples.

Mr. Wei made the following statement:

We appreciate this opportunity to discuss the operational issues of the statutory SDRM and hope this discussion will provide a basis for the upcoming IMFC meeting in making a better judgment on how to proceed with the establishment of an SDRM that will make crisis resolution more predictable and less costly. The staff is commended for the high quality paper which presents a more in-depth exploration of a feasible way for crisis resolution and a positive probe into PSI. To this end, we have the following observations on the proposals made by staff in the paper.

First, we support the proposal that the decision-making power to activate the SDRM resides with the debtor countries. Nobody else is in a better position to judge debt sustainability and make the important decision as to whether or not to resort to the SDRM. According to recent experience, countries usually make their best efforts to avoid a restructuring of debt. Hence, we may not need to worry too much that debtors may abuse the SDRM and restructure debt when they can still service the debt. We believe debtors always take into account all the benefits and costs from a long-term perspective and try their best to avoid a restructuring of debt that could be harmful to their reputations and hammer future financing opportunities from the international market. However, the incentive structure may to some extent have a bearing on the ease of using the SDRM.

Second, with regard to the scope of debt under the SDRM, we are not yet in a position to support the inclusion of domestic debt—at least at the beginning. Since the SDRM is a new approach dealing with crisis resolution and its effect has yet to be tested, we should not be too ambitious at the onset. It should first be targeted at where the major problem—i.e., collective action difficulties—resides in the sovereign debt restructuring process and the sovereign debt owed to foreign private creditors. Only when we are more confident in our knowledge regarding its advantages and disadvantages, can we move forward by deciding whether to include other debts, domestic debt for example, if it is deemed necessary. Furthermore, since in many cases there is already a legal tool to minimize the collective action problems for domestic debt, we do not see the urgent need to include domestic debt in the SDRM. On the issue of official bilateral debt, like Mr. Shaalan and Ms. Farid, we are also interested in learning from staff how to deal with non-Paris Club official bilateral debt. The views and interests of non-Paris Club creditors should be given equal attention in the SDRM.

Third, we generally agree that the key mandate of the dispute resolution forum should concentrate on claim verification and procedural works. Its independence from the IMF Board is essential to ensure its fairness. Also, we need to strike a representational balance between the developed and developing countries. Its operational framework and relationship with the Fund, however, remain to be further clarified. We agree that once the SDRM is activated by a certain debtor, important decisions and the restructuring terms should be reached by the debtor and super-majority creditors. While the Fund can continue to provide incentives for them to reach an agreement, we caution against giving the creditors too much leverage.

Fourth, on the legal issue, it does not seem to us that the paper makes it very clear what the situation would be if some national authorities have difficulty in adopting similar changes in their laws in line with the amendment of the Fund's Articles.

Finally, we share the view that creditor classification could bring about more flexibility and ensure a fairer process of sovereign debt restructuring. Like some other Directors, we believe that the pre-specification of classes in the text of treaty is preferable and creation of individual classes should be allowed in certain cases. However, we take note of the concerns expressed in the preliminary statements of Mr. Low and Ms. Phang and others that some further discussion on this issue is probably needed.

Mr. Bischofberger made the following statement:

We thank staff for a high-quality paper and, like Mr. Kiekens, I would also like to thank Ms. Krueger for her strong commitment to advance our work on the SDRM. Today's paper marks another valuable contribution to this endeavor. This chair continues to see great merit in the efforts to establish a statutory approach to sovereign debt restructuring in parallel with the contractual approach. Like Mr. Bennett, we see the SDRM as a key part of an integrated and comprehensive international framework for crisis prevention and resolution, with access policy in capital account crises, PSI, and the policy on lending into arrears being other important elements of that framework.

On the issues discussed in the paper, I can be very brief, since I can largely associate myself with the views expressed in several preliminary statements, including those of Mr. Andersen, Mr. Wijnholds, Mr. Padoan and Mr. Bennett. I also concur broadly with Mr. Kiekens's main conclusions in his intervention.

As regards the issue of the scope of debt to be covered by the SDRM, we generally think that it would be wise to focus at the outset on those categories whose coverage is crucial for achieving the goals of the SDRM. Implementation of the SDRM will already be complex as it is, and we should be careful not to unduly overburden the mechanism.

With these considerations in mind, debt owed to private creditors and subject to foreign jurisdictions should clearly be included in the SDRM. By contrast, debt governed by domestic law could in our view be excluded from the formal mechanism at this stage. While a restructuring of such debt may well prove to be unavoidable and even desirable, from the point of view of comparability of treatment in certain cases, this can be achieved with other means. For instance, international creditors could make comparability of treatment with domestic creditors a condition for a debt restructuring. Also, preferential treatment of domestically issued debt could be regarded as violating the "good-faith" principle, inducing the Fund and other international financial institutions to hold back financial support. In addition, it is worth noting, as others have done, that the need to include domestic creditors in a formal supranational mechanism is considerably lessened by the higher leverage the sovereign has vis-à-vis such creditors.

As to the Paris Club, like several other Directors, we would point out that this has proved to be a highly successful debt restructuring instrument. Therefore, while we would not altogether rule out an inclusion of official bilateral claims in the SDRM, we do not see a pressing need to do so at this stage. In the words of Mr. Wijnholds, "if it ain't broke, don't fix it". That said, greater coordination between official and private creditors might be worthwhile, even if official claims remain outside the SDRM.

Finally, on the Sovereign Dispute Resolution Forum, the ideas and procedures put forward by staff generally appear to be reasonable. I would like to add in this context that the proposed agency responsible for registering claims would be beneficial under any kind of crisis resolution mechanism, including the contractual approach.

Ms. Lundsager made the following statement:

We welcome today's discussion of the paper "Sovereign Debt Restructuring Mechanism—Further Considerations". This work complements well our work on the contractual approach and is another step forward in the international community's efforts to develop a more orderly and transparent framework for sovereign debt restructuring. The very nature of the exercise also highlights some fundamental issues that would have to be addressed to make the SDRM operational. We look forward to further discussion of these issues.

The staff has done an excellent job of exploring the issues and considerations involved in determining the scope of debt to be covered under the SDRM and the dispute resolution procedures. Some of their proposals merit further consideration, particularly those that would streamline the SDRM to the maximum extent possible. As we have said in the past, there is value in a simple, targeted approach, focused on external sovereign debt. At the same time, we strongly support aggressive pursuit of the contractual approach.

Allow me now to discuss some of the detailed issues raised in the paper.

Treatment of Sovereign Debt under the SDRM

We agree with the proposed definition of "external debt" as debt governed by foreign law or subject to the jurisdiction of a foreign country. This definition appears to be consistent with market practice and would be relevant to a contractual approach as well. The staff's proposal to create separate classes of creditors under the SDRM also seems reasonable. Under such an approach, it would be preferable to have flexibility within the treaty to establish classes, if for no other reason than likely market innovations would make such flexibility necessary. Given this agreement, I will focus the rest of my statement on the staff's discussion in their paper of possible approaches to the treatment of domestic and official bilateral debt under the SDRM and the potential features of a dispute resolution forum.

Domestic Debt

We agree with First Deputy Managing Director Ms. Krueger that excluding domestic debt from the SDRM has more promise than including it for several reasons. First, collective action issues do not normally hamper restructuring of domestic debt. Second, inclusion of domestic creditors as a class could allow them to hold up a restructuring of external debt that had been agreed. Third, the private sector is strongly opposed to including domestic debt in the SDRM for the same reason. Four, excluding domestic debt from the SDRM would limit the ability of the sovereign to manipulate the voting process.

Paris Club Debt

The staff has done a good job in laying out some of the very complex issues that need to be considered if bilateral official debt were included in a SDRM. We certainly do see scope for improved coordination between private and bilateral creditors in sovereign debt workouts, and acknowledge that the ad hoc Paris Club process raises issues in this regard. It is important to recognize, however, that issues with the Paris Club process do not in and of themselves provide a compelling rationale for an SDRM.

The fact that debtors' use of the SDRM channel would be voluntary, and that a menu of options could be provided to different creditor classes, increases the prospect for practical case-by-case arrangements. At the same time, it is important that private creditors would not be able to compel bilateral creditors to obtain appropriations to pay for debt reduction for certain debtors, nor force bilateral creditors to restructure in the absence of an IMF program.

Nonetheless, there are important concerns that would need to be considered further. These include the potential veto by private creditors on action by the public sector and the potential disruption to some of the most effective elements of the Paris Club process—including its flexible, consensus-based framework.

We suspect on balance that bringing the bilateral creditors into the SDRM would be negative for the debtor, as it would sacrifice an established process for resolving bilateral payments problems, since the Paris Club generally follows the IMF's advice on required concessions, and Paris Club agreements are usually reached quickly. In addition, bilateral creditors might at times benefit from the private creditors' more stringent negotiating position. At the same time, private creditors' reported concern that the Paris Club rushes in, steals the available cash in the near-term, and then forces an overly generous long-term deal, is overblown. The reverse argument—that the Paris Club escapes the concessions of private creditors through its traditional reluctance to cancel principal for non IDA-only countries—is similarly exaggerated.

Finally, the effects of this proposal on the IMF itself should be considered more fully. The IMF in its program design has a large voice in framing the scope of the Paris Club rescheduling and the assumptions for comparability of treatment. This role would likely change in an SDRM framework, with possible implications on how Fund programs and financing gaps are defined.

Sovereign Debt Dispute Resolution Forum

The SDDRF proposed in the paper is a useful basis for discussion. An SDDRF would be an integral part of the SDRM concept. The staff helpfully proposes the envisaged role, powers, and composition of the SDDRF. The proposed mechanism for selecting SDDRF members, while cumbersome, represents a start at seeking to ensure an independent SDDRF. However, as some other Directors have noted, the fundamental nature of the any proposed debt resolution mechanism remains open.

Miscellaneous Issues

The staff alludes in their paper to the possible use of Fund conditionality and lending into arrears policies to "encourage" certain behavior by sovereigns, including in the SDRM. It is important not to overemphasize the potential scope for these tools. Rigid application of either tool to encourage such behavior could constrain IMF program flexibility and raise potential conflict of interest concerns for the Fund. As we will stress in the upcoming discussion of Lending Into Arrears, it is important for the Fund to support good faith efforts, but an overly rigid approach is unlikely to be productive.

Finally, the paper states that that the sovereign debtor "could also decide to terminate the SDRM process if other procedures for restructuring its debt appeared preferable." Would the staff elaborate further on what this means? It seems to raise the risk that the sovereign could simply terminate the process if it does not like the probable outcome.

Mr. Brooke made the following statement:

Like other Directors, we continue to strongly support management's proposal for a statutory framework for sovereign debt restructuring. We fully agree with the discussion of the likely benefits of such a mechanism set out in Section 2 of the staff paper. I therefore would like to thank staff for this latest paper, which helps to move our debate further forward. If approved, the SDRM would play an important role in improving the Fund's crisis prevention and resolution framework, as many other Directors have commented. Having said that, we agree with Mr. Bennett that the SDRM is only one element in a system, and that the effectiveness of that system will depend on the application of all the various component elements that we are currently discussing.

As is evident from many of the comments in the thoughtful statements issued by Directors, a lot of complex issues have been raised in the staff's latest paper. I agree with Mr. Kiekens that the staff has already done a lot in terms of outreach. Nevertheless, I support Messrs. Portugal, Mozhin, Bennett and others in their calls for further and more formalized outreach to debtors and representatives from the various creditor associations. In this regard, I welcome indications from the Deputy Director of the Policy Development and Review Department that this is what the staff is planning to do.

As Mr. Fisher outlined in his comments at the beginning, the scope of the debt covered under the SDRM should be sufficiently broad to facilitate the achievement of two key goals, a comprehensive debt restructuring, and a sufficient degree of intercreditor equity that is acceptable to all creditors. Given these goals, our position on the question of coverage is similar to that of Mr. Bennett. In principle, we think that all sovereign debt should be included within the SDRM framework. We recognize, however, that when this is combined with cross vetoing power for a qualified majority of creditors in each class to approve the restructuring terms offered to all other classes, it could exacerbate the problems caused by holdout creditors, as also indicated by the staff representative from the Legal Department. Clearly, it would not be helpful if a qualified majority of domestic creditors could hold up a restructuring of external debt that had otherwise been agreed between the sovereign and the external creditors. Hence, if all sovereign debt were to be included, which does not seem likely given the tenor of remarks so far, we would want to consider the proposed veto powers a little bit further. That being said, it appears that if most Directors favor presumption to allow the debtor to choose to exclude domestic debt from the SDRM, I suspect that we would be able to join this consensus. However, like Mr. Andersen, we feel that in some cases it would be difficult to achieve our goals of intercreditor equity and sustainable debt if domestic debt is excluded. As such, we agree with Messrs. Padoan and Bossone that the SDRM agreement should be framed in such a way that domestic debt would not automatically be excluded in every case. Furthermore, in the instances when domestic debt is excluded, the sovereign would need to convince the external creditors that they were being treated equitably. In this regard, we agree with Messrs. Callaghan and Bennett on calls for adequate safeguards to ensure fair treatment to all creditors.

On classification elements, while we see the benefits of the staff's proposal to separate debt into creditor classes, we feel the numbers of such classes should be kept to a minimum. As Mr. Low and Ms. Lundsager have pointed out, because of the cross-veto position, the size of each creditor class will have a significant influence on how easy it will be for any creditor class to prevent a restructuring. One of the main advantages of the SDRM is its ability to facilitate the aggregation of claims across different debt instruments. As such, classes of debt need to be sufficiently broad to allow meaningful aggregation of instruments, while helping avoid the creation of new problems of holdout creditors. I have been reassured by the remarks of the staff representative in this direction. We agree with other Directors that the number of classes should be kept to a minimum and be pre-specified to the extent possible in the agreement. We also accept that there should be some scope for flexibility built into the system.

Turning to official bilateral debt, in principle we can support the inclusion of official bilateral debt in the SDRM. However, we recognize the merits of the arguments of those Directors who have suggested that this is not an essential element. Before reaching a decision on this issue, we feel that the staff should discuss it further with all of the various debtors and interested private and public sector creditors. We agree with those Directors who have argued in favor of increasing the information flows between the IMF official bilateral creditors and private sector creditors, and this point will hopefully be taken up in the discussion on lending into arrears that will follow the current Board discussion.

A greater change of information should help reduce the complaints frequently voiced by the private sector that they are presented with take it or leave it proposals over debt restructurings, which effectively leave them with no power to negotiate other options.

Finally, we welcome the further detail on the establishment of the dispute resolution forum. We fully agree with the basic principles outlined by the staff to guide the manner in which the SDDRF is established, its membership, and the way in which it functions. Like Ms. Lundsager, we broadly support the staff's proposals for the envisaged powers of the SDDRF. However, we share some of the concerns raised by a few Directors about whether the proposed selection and appointment procedures would be perceived as being sufficiently independent from the Fund. In this regard, I welcome again the comments made by the staff at the beginning of the discussion that this is still a very preliminary proposal, and we see merit in exploring some of the options suggested by other Directors.

As noted earlier, we feel that the next step going forward should be for the staff to discuss the proposals with representatives of debtor and creditor communities and to report back to the Board on the views that they express. We also agree with the staff's proposals that the next paper in this series should explore in more detail the relative treatment of secured and unsecured claims. As I mentioned earlier, we feel this could usefully highlight the pros and cons of the cross-veto provision in cases where there is a small number of creditors holding collateralized debt. We look forward to these papers and further progress on the SDRM.

Ms. Alcaide made the following statement:

I thank management and staff for the interesting papers presented for today's discussion. The staff paper is a useful contribution to the process of designing the framework to manage debt crises and resolution in an orderly fashion. The paper analyzes two of the most useful issues to be addressed in designing the SDRM, the treatment of domestic and official bilateral debt, and the establishment of a dispute resolution forum. However, we concur with other Directors that a deeper analysis and discussion would be needed before arriving to a definitive framework.

Going to the main issues under discussion, and as a general principle, we share the view that the sovereign debtor should be the only one to decide on activating the SDRM and determining the type of debt to be restructured. Nevertheless, it seems reasonable to include in the restructuring process all claims held by the private sector that are subject to foreign law or that were issued under the jurisdiction of foreign courts. The idea of allowing for creditor classification also seems reasonable, as it introduces flexibility in considering different types of creditors and instruments in the restructuring process. However, we must be aware that this system will give veto power to different kinds of creditors, which means that there might be a risk of blocking the negotiation process.

In relation to domestic debt, the staff opens the debate to the complicated issue of how to treat this type of debt. The staff suggests that defining domestic debt in terms of the legal jurisdiction under which the debt was issued instead of the traditional criteria of issuer residence or currency in which the instrument is denominated. Regardless of which definition is finally adopted, the need to decide whether to include domestic debt in the SDRM acknowledges the need to give a different consideration to this type of debt. In setting a strategy to confront crises—which requires a mix of economic adjustment, PSI and official support—one must evaluate the share of the burden assigned to domestic creditors considering the amount of sovereign debt that they hold, as well as the situation of the financial system. The effects of overloading the domestic private sector in a restructuring process may well be negative to both the financial sector and the real economy.

On the treatment of official bilateral debt, the staff paper does not clearly show advantages in including this type of debt in the SDRM, particularly with regard to Paris Club creditors. Given the principle of equal treatment and the existence of the Paris Club mechanism, one has to ask if it is necessary to include bilateral official debt in the restructuring process under the SDRM. We share the view that including this type of debt under the SDRM might well end up weakening the position of the Paris Club, which has a history of being an efficient restructuring mechanism.

Finally, we broadly agree with the staff on the proposed role and responsibilities of the SDDRF. Its powers should be limited to claims administration and dispute resolution, and it should be managed independently from the Fund's Executive Board. Nevertheless, we share the same concerns of Mr. Low and Ms. Phang on the proposed selection procedure of the independent and qualified committee to be established by the Executive Board.

Mr. Rouai made the following statement:

I join other Directors in their appreciation of the quality of the staff paper, and thank the First Deputy Managing Director for her statement (BUFF/02/131). The two documents jointly further advance the work in progress on the sovereign debt restructuring mechanism (SDRM). Hopefully, the final outcome will produce a mechanism that is simple, flexible, focused on resolving the specific collective action problems that constraint restructuring, and strike a fair balance between debtor and creditor rights, such that it could garner the necessary and broad support. In this connection, I encourage the staff to continue its outreach efforts so a to advance this work in a participatory way. Like Mr. Portugal and Mr. Zoccali, it is also important that the SDRM mechanism should not lead to unwarranted debt restructuring in those cases where adjustment and temporary financing could help achieve debt sustainability.

While it seems preferable to opt from the beginning for a comprehensive mechanism which includes a wide range of debts, it is perhaps more realistic to adopt a more cautious and evolutionary approach and start with a mechanism that could gather the necessary broad political and market support. Under this consideration, I favor the creation of a limited number of creditor classes and I believe that the SDRM should focus on classes that are currently perceived to constrain an orderly restructuring process.

I agree with the First Deputy Managing Director and other Directors' view that the proposed mechanism should not include domestic debt. Similarly, since a well-functioning mechanism is already in place, under the auspices of the Paris Club, to deal with the claims of official bilateral creditors, I do not see a need to further complicate the process. However, I encourage exploration of ways and means of enhancing cooperation between the Paris Club and private creditors.

Finally regarding the Sovereign Debt Dispute Resolution Forum (SDDRF), I welcome the four principles of independence, competence, diversity, and impartiality. Particularly important is the perception of independence of the Forum from the Fund. In this context, it would appear the proposal in paragraph 78 that "the Managing Director would make the appointment of each member of the SDDRF" could undermine the perception of independence. To further enhance the perception of independence, the appointments could be done by the Chairman of the Board of Governors. Also important to the same issue is the need to determine the sources, other than the IMF, of budgetary support for the operations of SDDRF.

Mr. Duquesne made the following statement:

I wish to thank Staff for their high quality paper on the establishment of an SDRM and specially like others the First Deputy Managing Director for her continuous involvement on that matter and especially today for her statement. We welcome this opportunity to pursue our discussion on a crucial component of our strategy to prevent and resolve financial crises. Let me recall also my authorities' commitment in favor of a statutory approach to this issue.

I will focus my intervention on three main topics.

First, we support the overall architecture of the proposed system, namely that the decision whether and when to activate the SDRM should rest with the sovereign debtor and that the consequent decisions should be reached by the debtor and a super-majority of creditors. Such an architecture should not, however, lead to a weakening of the role of the Fund in the overall mechanism: the IMF must remain a crucial player in the game, for example, in assessing the payment capacity of the debtor country and making a robust judgment of the sustainability of the country's debt based on several macroeconomic scenarios. In this context, the IMF should follow very closely and extensively the negotiations between the debtor and its creditors within the framework of an SDRM and retain its role of confidential advisor to the debtor country's authorities on how best to pave the way to debt sustainability.

On the creditor classification, we have no difficulty with the staff's proposal under the second bullet point of paragraph 23, that is pre-specifying certain classes in the text of the SDRM Treaty while allowing the creation of additional classes for individual cases. Flexibility is indeed of the essence, particularly when one takes into account the imagination and dynamism of international capital market operators.

Second, on the scope of debts to be covered by the SDRM, at this early stage of the design of an SDRM, we should remain pragmatic, flexible and open to lessons of experience. The idea of a comprehensive SDRM covering all claims is certainly attractive, none the least to a French and therefore supposedly Cartesian mind. Nevertheless, like many other directors, I believe that the mechanism we are designing should be targeted to those classes of debt for which the restructuring is currently hampered by collective action problems. We should not forget that our current discussions on the design of a mechanism to restructure sovereign debts have originated in collective action-related problems raised by the heterogeneity of international private creditors having incurred sovereign debts. In this perspective, an SDRM should, at minimum, include all claims held by private creditors that are either governed by foreign law or subject to the jurisdiction of foreign courts.

Many colleagues have already listed the numerous convincing arguments in favor of a differentiated treatment between domestic and external debt and I will not repeat them. Let me, however, stress one in particular: restructuring domestic sovereign debt is likely to have implications on the strength and viability of a country's banking and financial system, which is critical in the midst of a crisis. As expressed by Mr. Callaghan and Mr. Di Maio, in those cases, domestic debt therefore warrants separate and careful consideration.

Regarding the inclusion of official bilateral debt, I find myself in broad agreement with the arguments presented in Mr. Wijnholds's preliminary statement and by other colleagues orally. The Paris Club has indeed demonstrated its capacity to implement debt restructurings under a tight schedule and in close cooperation with the Fund's intervention. In that regard, we are concerned by the risk that a formal inclusion of the Paris Club into an SDRM at this stage might undermine the principles that have proved so useful over the years: nonlegally binding agreed minutes, consensus decision-making, comparability of treatment.

We therefore support the gradual approach advocated by Mr. Padoan and Mr. Bossone in their preliminary statement, whereby the SDRM treaty would be initially established under the presumption of exclusion of domestic and Paris Club claims. We would thus allow for some time to pass so as to accumulate experience and examine the relevance of these exclusions before assessing the desirability of moving to a presumption of inclusion rather than exclusion.

Third, we broadly share Staff's views on the Sovereign Debt Dispute Resolution Forum, although we concur with Mr. Andersen and Mr. Farelius that it is difficult to discuss the details of such an institution before the exact nature of the SDRM is determined. However, generally we support the idea that the SDDRF should operate independently from the board of the IMF and that its powers should be limited to administrative procedures and disputing resolutions.

Finally, since we will be faced with a long and arduous discussion, I would like to emphasize that in the meantime, this crucial debate should not distract us from our work in processing other aspects of the PSI strategy. Symmetrically, we should enter into other details of the design of the SDRM as soon as possible, namely, to cite but a few :

- the way the Fund will express its stance on the suspension of payments by the debtor country : will it be a formal agreement or an implicit one, for example through lending into arrears?

- the articulation between our SDRM strategy and the complementary contractual strategy based upon the extensive use of collective action clauses in sovereign bonds ;

- the possibility of some temporary restrictions on capital movements as a complement to the suspension of payments by the debtor country.

These issues, among many others, need to be examined carefully and diligently to progress decisively on the road to a full fledged SDRM and we encourage Staff to pursue efforts in order to maintain the very high quality of their work on this issue.

Mr. Reddy made the following statement:

We welcome the staff paper, and the note from the First Deputy Managing Director carrying forward the examination of the legal, institutional, and procedural aspects of the contractual and statutory approaches to improving the process of sovereign debt restructuring. Like other Directors, we have great pleasure in placing on record the high quality of the paper. We welcome the SDRM as a bold and desirable effort to building up better institutional mechanisms and practices, in dealing with crisis resolution and prevention, and improving stable conditions in the global financial markets.

The paper takes us a step forward in the discussion of two specific operational issues, namely the scope of the debt to be covered, and the mechanism of the dispute resolution procedures connected with the statutory approach. However, it will be useful to remind ourselves that several questions remain still somewhat open-ended on some of the issues already discussed regarding the design of the SDRM. First, what are the circumstances and cases where members are treated as having unsustainable debt burdens? Do we yet have a common approach to decide what an unsustainable debt situation is? It is true that work on these issues will continue as we develop the framework, but it is important to bear in mind that this remains an issue.

Second, since the SDRM is envisaged to be activated by the sovereign, will sovereigns themselves decide the status of their debt sustainability? If the unsustainable debt is defined in a rules-based manner, then what is the discretion allowed to the sovereign, and will such discretion, if it is allowed, not give rise to moral hazard?

Third, if the key decisions under the SDRM would be left to the debtor, and a supermajority of its creditors, what is the involvement of the Fund as a major financing institution? Will it just play a consultative role it its formal approval is not required? As we move forward, such concerns on technical aspects of the framework will have to be repeatedly addressed. Though not insurmountable, these are hurdles before finding a viable solution of an operational framework of SDRM. With this essential and very preliminary qualifying remarks, we offer our comments on specific issues raised in the current paper.

On the general features of the SDRM, this chair reiterates that, while a generalized and broad framework for SDRM may be feasible and desirable, a case-by-case approach should be taken as part of the SDRM package, including regarding the role of Fund-supported programs, and the institutional involvement of individual countries. Secondly, the SDRM should be treated as complementary to Fund emergency funding and certainly not as a substitute. Thirdly, the SDRM is likely to be significant for some countries, and to make the problem of moral hazard more acute. Hence, discussion on the SDRM should not minimize the importance of continued discussions on strengthening Fund resources through quotas and SDR allocation among others, as this would be beneficial to all members. In addition to increasing Fund resources, it is essential to build the overall confidence of the international investor community in the strength of the global financial architecture, and to protect the role of the Fund in that architecture.

On creditor classification, since the SDRM will be approached on a case-by-case basis, providing flexibility to the debtor country to determine the scope of debt restructuring, the creation of creditor classes may perhaps find a relatively favorable response from debtor countries. The feedback from private creditors would also be necessary to ensure that their concerns are being addressed. Several Directors have emphasized the need for wider and more structural outreach, and we note that the staff has assured us that this will be the case. I also agree with Mr. Kiekens that the First Deputy Managing Director has already made an outstanding contribution in this regard.

There is broad agreement that domestic debt should be kept outside the purview of the SDRM, but several issues are rightly raised in the staff paper related to maintaining acceptability for all creditor groups, ensuring intercreditor equity, and making the restructuring sufficiently comprehensive. We believe that these issues must be satisfactorily addressed to achieve a change in debt structure that will promote sustainability. The crucial thing is how sustainability can be defined in operational terms while precluding domestic debt. In a majority of cases, domestic debt is predominant, and a comprehensive restructuring program may have to necessarily take some account of domestic debt. Hence, to exclude domestic debt of the SDRM for all purposes may pose severe problems. It can be argued that the other alternative is to address sustainability only from the external angle. In a fast integrating debt market, and in some cases even with domestic debt linked to exchange and interest rates in international markets, and with foreign investors having freedom to invest in domestic markets, such a fine distinction between external and domestic debt could pose additional problems. It is quite possible that such a distinction will be particularly difficult in respect to those countries which have liberalized capital account transactions. Treating economic debt as a separate class and bringing it out of the SDRM in some very broad terms could provide a middle way, but this is an area that needs to be addressed.

Official bilateral claims represent a completely different type of debt and we totally agree that it cannot be compared or treated on par with marketable debt which can be traded in active secondary markets. Furthermore, the parties involved are sovereigns, both on the creditor and the debtor sides. As a matter of fact, the solution to restructuring is relatively simpler in such cases. We agree with the view that the official bilateral debt structuring should be outside the purview of the SDRM. Given the effectiveness of the Paris Club in dealing with these situations, it should be left to the Paris Club to decide on a case-by-case basis preferably, the manner of their participation in the SDRM, either directly or indirectly, or even whether this debt should remain totally outside the SDRM.

The last part of the staff paper talks at length about the creation of an institutional structure and about its composition. The principles set out for the SDDRF are most appropriate, and the details of composition powers are broadly consistent with these principles.

To sum up, the paper takes consideration of the critical issues connected with the statutory approach and its precedents in a comprehensive and very competent way. Several complexities regarding the basic elements of the SDRM are adequately fleshed out in the staff paper, and analytics are excellent, but operationalization of these complex issues is the real issue. We appreciate the valuable work done so far on the subject, and we urge continuation of work emphasizing the need for outreach and for addressing several operational issues also raised by many other Directors.

Mr. Ondo Mañe made the following statement:

We thank the staff for a very comprehensive paper, and the First Deputy Managing Director for her strong involvement in this matter. Overall we agree that the SDRM could represent the missing link in the new international financial architecture for an orderly and predictable debt restructuring. As governors indicated during the spring meetings, we should move ahead with the new mechanism. We also agree with the staff that the diversity of instruments and creditors to be covered under the debt restructuring framework calls for more flexibility and predictability in the design of the SDRM. I will make a few remarks for emphasis.

With regard to the treatment of domestic debt, our views are similar to those expressed by Messrs. Low, Portugal and Shaalan. We think that domestic debt should be excluded from the scope of the SDRM.

Turning to the issues of the treatment of bilateral creditors, the Paris Club has been very effective in dealing with this issue, and major adaptations have been made over the past four decades. In view of the staff's answers and of Mr. Duquesne's clarification, we call for more discussion between the staff and the Paris Club secretariat. Therefore, we favor the status quo, but we also call for enhanced cooperation between the private creditors and the Paris Club.

Finally, turning to the issue of sovereign debt dispute resolution, we see the framework proposed in the staff paper appropriate, although we favor a more transparent approach to the selection process through a system whereby creditors and debtors will be equally represented.

Mr. Cippà joined other Directors in thanking the First Deputy Managing Director for her personal outstanding contribution in the promotion of the difficult issue of the SDRM, and, after listening to the statements of all other Directors, he qualified the position expressed in his preliminary statement regarding his strong preference for the SDRM to include all categories of debt in order to have as broad and comprehensive a framework as possible. Political feasibility would obviously play an important role in the pursuit of such far-reaching objectives, and as indicated by the First Deputy Managing Director and by several Directors, political acceptance would dictate a somewhat less comprehensive scope for the initial SDRM. While it was important to address the issues under discussion from a fundamental and comprehensive perspective at the current early stage of the process of designing the operational features of the future SDRM, his chair would be willing to join the emerging consensus on a less comprehensive SDRM in the future if this could increase the feasibility of establishing an SDRM.

Mr. Low agreed with Mr. Duquesne that the Fund should continue to play the role of confidential advisor under the new framework. He also asked whether the debtor would be expected to be in negotiations to obtain a Fund-supported program once the SDRM had been activated or whether the issue of Fund support could be treated as a separate subject.

Mr. Kiekens made the following additional statement:

> I want to pay at the end of this discussion a tribute to a former colleague, Mrs. Lissakers, who has written an interesting book on banks, borrowers, and what she called the establishment, in which she explains the relation between creditors and sovereign debtors. I would like to quote several passages from that book to demonstrate what an enormous progress we are making in discussing the SDRM.
>
> The first quote refers to the definition of sovereign debt. She says that when one of the parties to a lending contract is a sovereign state, the relationship is inherently unequal. The definition of sovereign that she uses, quoting from the Webster dictionary, is the supreme controlling power which has absolute and independent authority. Later into the book she concludes that courts of law have historically offered little comfort to creditors, generally holding that anyone foolish enough to assume "the notorious risk of lending to a sovereign" was on his own when it came to the time of repayment. She then gives some examples of how creditors took their precautions in the middle ages. When James II of Scotland had to borrow 60,000 florins from Christian I, King of Denmark, he had to pledge his title to the Shetland Islands as security. To give another example that relates more directly to my constituency. The creditors of Maximilian I of Austria required him to surrender the royal jewels of the House of Burgundy as collateral, and here I want to explain that Prince Maximilian married Mary of Burgundy, so he was pledging not his own jewels, but those of his wife, Mary of Burgundy, who was of Flemish decent.

Nowadays, creditors no longer require the state to pledge the jewels of the wife of the president or prime minister, but they still try to protect themselves by having their contracts governed by foreign law. Even so, that has not been very helpful because the traditional doctrine of sovereign immunity has virtually barred private suits being brought against the foreign power. In this regard, I would like to quote an opinion of the British high court from 1851, which sums up the doctrine on sovereign immunity under Anglo-Saxon law. The court concluded that citing a foreign potentate in a municipal court, meaning a court in London, was contrary to the law of nations and an insult, which the sovereign foreign king was entitled to resent.

The American and British states have recently tried to help creditors by making it easier for private parties to take a foreign government to court by enacting legislation that distinguishes between purely commercial and other official activities of the foreign state in their jurisdiction, and by allowing under the U.S. Foreign Sovereign Immunities Act of 1976 to waive immunity of attachment for commercial property. The current Board discussion focuses on the powers of private creditors to agree or disagree with the need for a sovereign to default, which is a significant step compared to the past framework where sovereigns defaulted without any legal remedy. My overriding conclusion from the current discussion is that we are moving in the direction of creating a rescheduling mechanism for private external creditors, another one for bilateral creditors—the Paris Club—and yet another one for domestic debt when that is needed. The remaining economic and legal challenge that will require further consideration is how to ensure consistency in the decision-making under these three separate mechanisms, so that an overall sustainable debt can be reached.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to a question from Ms. Lundsager on whether debtors would be able to opt out of the mechanism, observed that debtor countries would not be compelled to invoke the SDRM, but merely given the option to do so. Sovereigns could still reach an agreement on a voluntary debt exchange with a group of creditors outside the mechanism, but it would not be possible to remove the legal protection from those creditors which did not accept the deal if the agreement had been reached outside the SDRM framework. These creditors would still be able to utilize the full range of legal remedies available to them in the instrument documenting their claim. This would be somewhat different from the nonsovereign debt restructuring framework, as corporations were not able to opt out from domestic restructuring procedures once they had been set in motion. Such an obligation could not be imposed on sovereigns.

Regarding Mr. Low's question on a possible requirement for a formal declaration by the Fund that a member's debt would be sustainable after a debt restructuring, the Deputy Director pointed out that such a formal role for the Fund was not currently envisaged under the proposed framework, although the Fund would obviously be making those assessments in the course of its normal activities concerning its own lending decisions.

The Acting Chair (Ms. Krueger) made the following summing up:

We have had a constructive and thoughtful discussion of possible features of a new Sovereign Debt Restructuring Mechanism focused on the treatment of different types of sovereign debts and a sovereign debt dispute resolution forum. The views expressed today will help shape the development of the mechanism, and provide valuable guidance to the staff for future work. There is broad support among Directors for a statutory debt restructuring mechanism, as well as a development of collective action clauses, to improve the international financial architecture.

Most Directors reiterated the view that the current process for the restructuring of sovereign debt is more prolonged, more damaging to a debtor and its creditors, and more unpredictable than is desirable. They welcomed the opportunity to give further consideration to a possible mechanism that could provide incentives for a debtor with a clearly unsustainable debt burden, and its creditors, to reach rapid agreement on a restructuring that helps pave the way toward a return to fiscal and balance of payments sustainability. They considered today's discussion, following the earlier one on collective action clauses, to have been a further important step in examining the legal, institutional, and procedural aspects of the two proposed approaches to sovereign debt restructuring.

Directors observed that debt restructuring is only one element of a comprehensive framework for resolving a member's problems, and that the need for continuing support from the Fund during the restructuring process is important for orderly economic adjustment. Some Directors stressed that care should be taken to ensure that an eventual SDRM does not lead to restructurings that might have been avoided with continued adjustment and more temporary official financing.

Scope of Debt Covered by the Mechanism

Directors welcomed the opportunity to discuss the complex issues associated with the scope of debts that could be covered by an SDRM, and the ways in which the restructuring of different types of debt could be coordinated.

Directors agreed that the scope of debts that might need to be included in a restructuring should be sufficiently broad, so as to secure an adequate reduction in the debt and debt-service burden and to achieve sufficient intercreditor equity to garner broad support for a restructuring. They considered that the coverage of individual restructurings would need to be decided by debtors in light, inter alia, of the willingness of the Fund to support a program based upon such a restructuring and the ability to reach agreement with creditors.

Directors underscored that the potential complexity and diversity of both instruments and creditors highlight the need to allow flexibility in the design of the SDRM. As creditors may have different types of claims on a sovereign and may not be similarly situated, Directors noted that it would be difficult to aggregate all claims on the sovereign for voting purposes into a single vote. Accordingly, Directors indicated that the establishment of a classification system whereby claims are aggregated within—but not across—classes for voting purposes would be appropriate. Directors also noted that such a system could facilitate restructurings by enabling the debtor to offer different terms to different classes of creditors based on the different nature of the claims held by the class in question as well as their particular preferences. The classes should be made sufficiently broad and their number kept to a minimum; the approval of each class would be required to complete the restructuring, giving each class an effective veto over a restructuring done through the SDRM. Most Directors considered that, in order for the SDRM to adapt to the evolution of the capital markets, it might not be desirable to pre-specify all of the classes in the text of the treaty establishing the SDRM. Some Directors noted that the existence of veto power could prolong the debt restructuring process, and suggested that care be taken to ensure that the classification process does not create potential hold-out problems.

Directors also considered that the mechanism would not necessarily need to encompass all sovereign obligations for it to provide an effective framework for coordinating a comprehensive restructuring. They were in favor of keeping the mechanism simple and tightly confined to addressing specific problems that may cause difficulties for sovereign debt restructuring. In particular, they considered that types of debt that can be restructured without giving rise to severe collective action difficulties could be excluded from the mechanism without jeopardizing the authorities' ability to restructure such claims. They noted though, that it would be important to include those debts for which the SDRM would provide the sovereign with effective tools to overcome collective action difficulties. Directors agreed that sovereign debts governed by foreign law or under the jurisdiction of foreign courts would need to be covered by the mechanism in order to allow the sovereign to use the tools for addressing collective action difficulties.

Domestic Debt

With regard to domestic debt, Directors emphasized the need for considerable caution in the design of restructurings, particularly with a view to paving the way toward a relatively rapid return by the sovereign to domestic capital markets and preserving at least a core banking system. Directors noted that domestic debt restructuring would also have implications for monetary control, and that a program's reserve floors and monetary targets would play a crucial role in determining the scope of the domestic debt restructuring that would be needed.

Regarding the treatment of domestic debt under the SDRM, Directors agreed that governing law and the jurisdiction of the claim provided the best basis for distinguishing domestic debt from foreign debt. For sovereign debts governed by domestic law and subject to the jurisdiction of domestic courts, most Directors considered that members already have adequate tools for restructuring such instruments, and that they should be excluded from the SDRM at least initially, though consideration could be given to establishing a procedure that would allow the coverage subsequently to be extended. A few, however, considered that there would be benefits in ensuring that the SDRM is comprehensive, and thought that domestic debt should be included, albeit as a separate class, and that the consequences of policies on the value of credit denominated in local currency be taken into account in any restructuring of external debt. A number of Directors noted that the Fund should avoid encouraging sovereign debtors to use its sovereign powers to unilaterally restructure domestic claims unless an overall restructuring process is in place that has the support of the international community.

Official Bilateral Debt

Directors reiterated their view that the Paris Club provides an effective and flexible mechanism for restructuring claims of official bilateral creditors and mobilizing support from such creditors for members' adjustment programs. They cautioned that considerable care would be required in addressing relations between the SDRM and the Paris Club in order to preserve the Club's ability to provide early support, while providing the flexibility needed to address intercreditor equity concerns in the more complex cases in which both private and official bilateral creditors have substantial exposure. Some Directors considered that it is premature to form a firm judgment of the treatment of official bilateral debt under the SDRM before they had the opportunity to hear the views of Paris Club and other official bilateral creditors. Some Directors, however, considered that there were substantial benefits in including official bilateral creditors within the SDRM as a separate class. Some Directors also noted that the claims of non-Paris Club bilateral creditors would need to be taken into account in designing the SDRM. Nevertheless, the preliminary view of the Board was that official bilateral claims should be excluded from the SDRM, at least initially, but that close coordination would be needed between Paris Club and SDRM restructurings.

Sovereign Debt Dispute Resolution Forum

Most Directors recognized that one of the advantages of establishing the SDRM under an international treaty is that it provides a basis for the creation of a single and exclusive dispute resolution forum that would provide for legal uniformity in all jurisdictions and ensure uniform interpretation. At the same time, a few Directors expressed concern that the establishment of a Sovereign Debt Dispute Resolution Forum (SDDRF) could conflict with national laws and face political obstacles in a number of countries.

Regarding the powers of the SDDRF, Directors agreed that its role should be limited to the administration of claims and the resolution of disputes. Some Directors expressed concern that the creation of creditor classes on a case-by-case basis would likely give rise to disputes whose resolution would require the exercise of considerable discretion by the SDDRF. Directors agreed that the SDDRF should not have authority to challenge decisions made by the Executive Board or to overrule decisions made by the requisite majority of creditors.

Directors agreed that the relevant rules governing the composition of the SDDRF should be guided by four basic principles: independence, competence, diversity and impartiality. They stressed, in particular, that the SDDRF should not only be independent, but also must be seen to be independent. While Directors felt that it was too early to decide upon the rules that would be put in place to implement these principles, many Directors were of the view that the framework outlined in the staff paper provided a useful basis for further discussion. Some Directors expressed the view, however, that this framework would be unnecessarily cumbersome, or that the procedure outlined for selecting the members of the Forum could raise questions about the independence of the Forum and undermine its legitimacy.

Next Steps

Directors encouraged management and staff to continue to examine possible design features of an SDRM, and indicated that they would welcome a paper that takes stock of progress on both the statutory and the contractual approaches and discusses how best to move forward by the end of the year. However, a number of Directors stressed that further outreach is needed by the IMF to engage the private sector and emerging market sovereign borrowers in developing a more concrete set of recommendations and to build consensus on the design of the SDRM.

2. FUND POLICY ON LENDING INTO ARREARS TO PRIVATE CREDITORS—FURTHER CONSIDERATION OF GOOD FAITH CRITERION

Document: Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion (SM/02/248, 7/31/02)

Staff: Fisher, ICM/PDR; Allen, PDR; Hagan, LEG

Length: 1 hour, 55 minutes

Mr. Bennett submitted the following statement:

As with other policies pertaining to crisis prevention and resolution, a key requirement for Fund policy on lending into arrears is to establish the right incentives for debtors and creditors. In the case of lending into arrears, that means getting the necessary conditions for satisfying the "negotiating in good faith criterion" right and communicating them clearly. It also means, of course, that such lending should be subject to all the relevant requirements of Fund lending such as access limits, a high quality debt sustainability analysis, and appropriate documentation. In this regard, I think the paper would have benefited from more discussion of the interaction of these other elements of Fund policy and lending into arrears. Each addresses one aspect of a common problem, and the effectiveness of efforts in one area depends on what is done in the other areas.

As the paper shows, it is difficult to define a satisfactory one–size–fits–all approach to negotiating in good faith. We support the third approach suggested by the staff with clear principles as the guide. While the debtor should have the flexibility to choose the approach to dialogue that it thinks best, whatever approach it chooses must satisfy two key principles:

(1) inter–creditor equity must be ensured

(2) all relevant information must be provided to all creditors on a timely basis

In addition, the Fund should be obliged to justify any decision to lend into arrears. All decisions to lend into arrears should be based on a staff paper that makes the case that the country in question is negotiating in good faith with its creditors. It should be required that the paper include the views of a sufficiently broad spectrum of private creditors and it should be mandatory that the paper will be published. This should go a considerable distance to addressing the private sector's skepticism about the Fund's ability to be an impartial arbiter in debt restructurings.

Finally, I would like to note that negotiating in good faith is not a sufficient condition to require the Fund to lend into arrears. And, in deciding whether to lend into arrears, the Fund should take account of the fact that arrears are often a significant short–term source of finance which mitigate the effects of the closure of capital markets to the debtor. I would also like to hear from the staff on what strategies they have to avoid being gamed into, at least partially, bailing out creditors in the event that access policy is left highly flexible and ambiguous.

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

We welcome today's paper which seeks to clarify the Good Faith Criterion introduced in 1999 following the modification of the Fund's policy of lending into sovereign external payment arrears to private creditors to include arrears on international sovereign bonds and other nonbank forms of private financing.

Since the introduction of the Good Faith Criterion in 1999, the two pillars of the Fund's arrears policy have remained the same and, it appears to us, have been implemented rather smoothly. The first pillar of the Fund's policy is, of course, the judgment that prompt Fund support is essential for the successful implementation of a member's adjustment program. The second pillar is that the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors, and thereby providing the Fund with a sufficient degree of confidence that a debt restructuring agreement would be reached with private creditors within a reasonable period of time. As indicated in the paper, the "good faith effort" criterion replaced the original criterion that stipulated that debtor–creditor negotiations should have begun before the Fund could actually lend into arrears. The criterion was modified due to the concern that coordination and other difficulties stemming from the large number and potentially disparate interests of bondholders could well cause creditors to delay the start of negotiations and thereby effectively prevent the extension of Fund support even if the member was conducting appropriate policies. An assessment of whether the member was making "good faith efforts" to reach a collaborative agreement with creditors was viewed as more appropriate and as providing a better incentive structure to both debtors and creditors to initiate and conduct serious restructuring negotiations. This test provides the Fund with the needed flexibility to exercise its judgment on a case–by–case basis and avoids the situation where bondholders could exercise a de facto veto over Fund lending.

The staff paper informs us that issues have arisen in the application of the policy concerning the meaning of "good faith efforts to reach a collaborative agreement with creditors," and seeks to clarify the issues surrounding the nature and the extent of dialogue between a member and its creditors required to satisfy this condition. The paper proposes a set of general principles that would guide a timely and substantive dialogue between a debtor and its creditors in the context of elaborating restructuring proposals. However, it seems to us that in the process of identifying this set of principles, the paper has gone somewhat beyond its stated purpose. In fact, it seems to have digressed to the subject of how to improve the restructuring processes to make them more predictable, less protracted and subject to less uncertainty, which in our view, though of utmost importance and relevance, belongs to another discussion, namely that of Restructuring International Sovereign Bonds, (through Collective Action Clauses and the SDRM proposal). Thus, in our view, today's discussion should be limited to the refinement of the "good faith criterion" and should refrain from setting definitive rules as to how the debt negotiations themselves should be conducted. The aim of today's discussion should be simply to clarify how the Fund would come to its judgment that the member is making a good faith effort to negotiate with its creditors. In doing so, it is of utmost importance that the Fund's lending into arrears policy remains sufficiently flexible to enable it to fulfill its core purpose, which is to enable the Fund to provide timely balance of payments assistance to members that are implementing sound adjustment policies. Flexibility means that the policy should continue to be applied on a case–by–case basis. The recent two track proposals for crisis resolution, namely the SDRM and the CACs, would admittedly complement the Fund's lending into arrears policy, once agreement by the international community is reached on these matters, but we are not at that stage yet.

We find the principles set forth in Section III, (A) of the paper to be appropriate for the purpose of clarifying the Fund's "good faith criterion". Thus we concur with the importance of (a) an early dialogue with creditors, which should continue until the restructuring is complete (with the general expectation that the dialogue would be initiated prior to the member's agreement with the Fund on a program, (b) the sharing of relevant non–confidential information with all creditors on a timely basis, and (c) providing creditors with an early opportunity to give input on the design of early restructuring strategies and the design of individual instruments.

Debtors should be allowed a sufficient amount of flexibility in the modalities of their dialogue with their creditors, in the context of the lending into arrears policy. As noted in the paper and as recent experience has shown, Fund policy should enable a diverse range of cases to be addressed effectively. In some cases informal mechanisms may be sufficient, while in others a more organized collective negotiating framework may be appropriate. The crucial test for the Fund should remain that the debtor is negotiating in good faith with its creditors. Thus, we are not in favor of stipulating that once creditors have organized a representative committee on a timely basis, then the member must conduct negotiations with that committee according to a set of best practices adopted by the private sector (as presented in Section III, (C) of the paper). Such a stipulation would limit the flexibility of the arrears policy and would once again raise the concern that creditors would be given excessive leverage over Fund lending. Our view is that setting too many guidelines would seriously constrain the flexibility needed in the application of the lending into arrears policy, and thereby rob it of its effectiveness. We must also note here that we are particularly concerned that the staff paper is in fact proposing the wholesale adoption of a set of best practices drafted solely by the private sector. At the very least, the views of potential sovereign debtors should have been sought and presented.

To conclude, our preference would be to adopt the paper's so called first approach, but to clarify it by adopting the principles set forth in Section III, (A). This would render the policy more transparent, while maintaining the required degree of flexibility for its effective operation. The second approach is clearly unacceptable because it would lack the flexibility required for the policy to be credibly applied to a wide range of circumstances. The third approach, while presented in the paper as striking a balance between competing considerations, in our view, as noted earlier, still effectively curbs the policy's flexibility and enhances the leverage of the creditors vis-à-vis the debtor and the Fund. We would note however that we can support the elements listed in paragraph 44 as part of the third approach, that would go into the Fund's assessment of whether the member should be expected to enter negotiations with a creditor committee or to pursue a less structured dialogue. We believe these could be incorporated into the first approach. Our main concern with regard to the third approach lies mainly in the content of paragraph 45, which states that for the purpose of making the assessment on whether the member was negotiating in good faith with a creditor committee, the Fund would evaluate the extent to which the debtor and the creditors are adhering to the principles set forth in Section III, (C). As noted above, we have serious reservations to the Fund, in its assessment of good faith efforts, adopting principles set exclusively by the creditors in the absence of input from the sovereign members concerned.

Mr. Callaghan submitted the following statement:

Key Points

In making assessments whether the debtor is making good faith efforts to enter into negotiations with creditors, flexibility is necessary so as to allow for different cases and circumstances. There is no 'one size fits all' model and the official sector should not attempt to micro manage the process.

The third option raised in the paper for refining the assessment of good faith has the advantage of providing for flexibility while outlining some factors to be taken into account in making the assessment as to whether the debtor is making good faith efforts. However, it always has to come down to a judgment based on the circumstances of each case and ultimately a consistent application of these principles over time will be required to demonstrate a clearer approach to lending into arrears.

There are risks and costs associated with requiring members to apply the principles outlined for negotiating with creditor committees and these need to be canvassed.

Further advice as to how the issues raised in this paper fit into the SDRM proposal would be appreciated.

Strengthening debtor–creditor dialogue in the good times is particularly important because this will provide a good base for advancing the required negotiating framework in times of stress.

The thrust of the paper is on the right track. The lending into arrears policy can help limit the scale of economic dislocation if the debtor is prepared to implement the appropriate adjustment program. The policy can also help maintain the value of the assets of the creditors. In implementing the policy, it is appropriate for the Fund to put the emphasis on the debtor engaging in a constructive, 'good faith' dialogue with creditors in an effort to reach an agreement that will assist in the debtor regaining viability.

In implementing the policy, history shows that flexibility is required. Reflecting on international experiences with sovereign debt restructuring in the late 1990s, the diversity of the cases demonstrated that there was not a 'one size fits all' prescription to the resolution of debt problems – the tools and techniques used to bring about co–operative solutions come from a combination of informal mechanisms and more concerted approaches. The official sector needs to be careful not to 'micro manage' the debt restructuring process, nor inhibit the market's ability to develop innovative solutions to complex problems.

We agree there is value in clarifying the criteria used to decide whether a member is negotiating in good faith with private creditors. However, further clarification by the Fund on the good faith criteria will not directly address many of the substantive concerns mentioned by private creditor groups. These groups have highlighted issues regarding inter–creditor equity, the definition of debt–service payment envelopes, and the design of individual instruments issued in the restructuring, which suggest that their concerns are predominantly issues of substance and detail and not simply the processes and principles discussed in the paper.

The third approach outlined in the paper for refining the assessment of the 'good faith' criterion in the lending into arrears policy is clearly presented as being the preferred option. As the paper notes, it attempts to strike a balance between the need to promote dialogue between debtors and creditors while recognizing the variety of individual country circumstances. Requiring the debtor to invite creditors to form a committee, as proposed in the second option, is clearly too prescriptive. However, it is not quite clear how the preferred, third option will work in practice.

As with the existing policy, the Fund will ultimately have to make an assessment whether the debtor is making good faith efforts. The main advantage of the third approach appears to be that it outlines some factors that need to be considered (by the Fund) in making the assessment whether a debtor is making good faith efforts to reach a collaborative agreement. However, judgments will still need to be made on such matters as to the complexity of individual cases and the reasonableness of the terms being requested by creditors. These are presumably factors the Fund already takes into account in making assessments whether the debtor is engaging in good faith negotiations. So the third approach outlined in the paper has merit, but it will still come down to making difficult judgments. The key is that consistent application of these principles over time will be required to demonstrate a clearer approach to lending into arrears.

The section outlining the implication for debtors of following a more organized negotiating framework suggests that they will gain many advantages. Yet it seems that sovereign debtors have at times found it expedient to adopt a strategy that avoids negotiations with any organized group of creditors. In addition to the benefits of an organized framework canvassed in the paper, there are also risks and costs. In the past, sovereigns have made the judgment that the costs and risks outweigh the benefits. One of the concerns debtors have cited has been that a collective framework can provide a platform for dissident creditors to rally support.

Moreover, while creditor committees offer advantages as a way to develop a co-coordinated voice for creditors, we need to be conscious of the heterogeneity of the creditor base in modern financial markets which gives rise to creditor conflicts (different interests, different agendas) and hold up the negotiation process. Furthermore, trading of debt instruments on secondary markets can quickly change the representative balance/weighting of creditor committees.

The difficulty of any perception that the Fund is imposing a more organized negotiating framework on debtors is that it is in a better position than the member to assess the costs and benefits involved. At a minimum, an analysis of the costs and risks of adopting an organized negotiating structure is required.

There is also an asymmetry between the incentives for debtors and creditors to implement the principles for an organized negotiating framework. In particular, while Fund lending would provide an overwhelming incentive for the debtor to negotiate with a committee in a manner consistent with the principles, there is no similar incentive for the creditors to agree, and importantly maintain a standstill on litigation during the negotiating process. This imbalance creates the perception that the impact of this policy decision may be to strengthen the hand of creditors in the negotiating process.

One aspect that is not clear is what the preferred approach means for the SDRM. Is good faith automatically deemed in the case of the SDRM? It will be important that the lending into arrears policy be applied consistently between those countries that do not go down the SDRM route in restructuring their debt with those counties that do.

We have a few other comments on the paper:

The observation that channels of communication established in normal times can be particularly valuable in times of stress is a prescient one. Members are much more likely to be able to make informed assessments about what degree of structure is required in the negotiating framework where a foundation for debtor-creditor dialogue exists. Strengthening dialogue in normal times is to be encouraged for this reason.

If the current push for the increased inclusion of contingency clauses in bond contracts is successful, this will assist the processes discussed in the paper. Even where an organized negotiating framework is not appropriate, contingency clauses may provide a set of norms to guide negotiations and shape expectations about the process without denying flexibility. This should not only lead to a more effective process, but in some cases will provide a benchmark for judging 'good faith'.

Mr. Mozhin and Ms. Vtyurina submitted the following statement:

We welcome the continued attention being paid to the Fund's policy on lending into arrears to the private sector. At present it seems the right time to clarify the elements of the Fund's "good faith effort" principle in facilitating the debt restructuring process. As the previous modification of the Fund's guidelines in this area has helped to accommodate for the changing environment of sovereign financing of the 1990's, the very recent debt crises and the experience with sovereign debt restructuring certainly warrant further amendments to the existing policy.

The debate on this issue appears to be a rather active one both in the official and private sectors. While there are serious differences of opinion on some of the issues regarding sovereign debt restructuring, such as, for example, burden sharing between the two sectors, there are lesser disagreements on the issue of a need for an appropriate negotiating framework. From what we have learned from the staff paper and other sources, both parties, the Fund and the private sector's buy–side, in particular, see it necessary to establish a better set of rules to guide the restructuring process both at the inception and after the default. As one of the Emerging Markets Creditor Association (EMCA) co–founders have put it: "No–one is asking for a guaranteed outcome. But people [investors] are asking for clear procedures. The idea is to have a set of guidelines that allow debt workouts without undermining the asset class" (Euromoney, 2001).

Thus, it is especially commendable that the staff have turned to the private sector to seek its ideas on the features of an organized negotiating framework (Section III (C)) so that to add them to the ones proposed by the staff themselves (Section III(A)). We would like to learn from the staff about which private organization(s)' principles were used as a base for the proposed framework (Council on Foreign Relations (CFR), EMCA, International Institute of Finance (IIF), etc.). Based on this Chair's previous position regarding the need to incorporate the private sector principles into the Fund's rules on lending into arrears, we are prepared to endorse the currently proposed framework. Moreover, we regard this as a major positive departure from the Board's previous decision regarding CFR principles, for example, when it was considered that although "the principles on debtor–creditor negotiations, as proposed by the CFR, could provide one of a number of possible approaches to reaching collaborative agreement, they [Directors] generally did not consider it appropriate for the Fund to endorse these principles".

At the same time, as the private sector, we also realize that across–the–border application of such rules will not always be feasible as country circumstances can be quite different. Therefore, we also continue to endorse a case-by-case approach while applying the principles under the framework to the extent possible. The case–by–case, or discretionary, approach, however, also has several implications. One of such implications, and a rather serious one, is the ambiguity of the Fund's access limit policy. Until the Fund communicates clearly to the private sector on what basis countries are receiving financial assistance packages (or "bailouts") from the Fund before or after default, it would be really difficult not only to play by the established "rules", but also to make fair decisions on a case-by-case basis. Indeed, the IIF, for example, expressed the following regarding this issue: "The IMF and Paris Club support for adjustment programs should be formulated in a consistent and predictable manner within the framework of their established policies". This said, we await the outcome of the upcoming discussion on the access limit policy to hopefully shed some light on how this issue can be addressed.

In the meantime, we regard the proposed principals as appropriate guideposts to a constructive dialog between creditors and debtors both before and after the default. As to the potential implications of such a framework for the debtors suggested by the staff in para 31, we do not find them very convincing. The issue of standstills is perhaps the only one that stands out given its importance in preserving creditor rights and inter-creditor equality, on the one hand, and allowing the debtor time to prepare a viable stabilization program, on the other. As this issue going to be addressed in future discussions on the SDRM, for now, it seems fitting to leave a principle of a voluntary standstill intact within the proposed framework.

We see it appropriate to refine the existing Fund's policy on lending into arrears by making the proposed third approach operational. We agree with the staff that this approach tries "to strike a balance between the need to promoting dialogue between a debtor and its creditors, on the one hand, and the diversity of individual country circumstances and uncertainties concerning whether or not creditors would organize a representative committee in timely fashion, on the other". We have not, however, completely grasped how this approach will be actually incorporated in the decision making process when the program is being designed. Will there be a special section in the staff papers at the program initiation and reviews devoted to assessing the "good faith effort" according to the proposed principles/framework?

Any process involving a case-by-case approach is bound to be highly judgmental on the part of the Fund. While flexibility should be preserved when assessing the member's "good faith efforts", excessive discretion should be avoided. In this regard, we can already foresee the difficulties in making judgments on at least two merits—the complexity of the case and sufficiency of representation of a creditor committee. A third issue, of no less complexity or importance, is making a judgment on whether the negotiations are stalled because creditors' demands are inconsistent with the Fund program's parameters. On this latter point, it would be especially important for the debtor to consult with the creditors on the macroeconomic and financing parameters of the Fund's program in order to avoid or reconcile the differences, and, not least, to gather a variety of opinions that will help design the most realistic program assumptions. Naturally there should not be any question about private creditors having a veto over the design of the program, yet this point seem to be overemphasized in the paper.

Finally and based on the above considerations we believe that the staff's statement that "the credibility of the Fund' policy [of lending into arrears] will depend, in part, on a perception that the Fund actively promotes collaborative resolution to debt difficulties that are seen as being generally fair to all parties" should be made very explicit. While the Fund should provide early support for the members' adjustment programs and lend into arrears even if the fulfillment of some parts of the framework is lagging behind, it should also make it well understood to its members that a rapid progress toward collaborative agreements on debt restructuring is in their best interest and is essential for medium-term sustainability and further financing from both IFIs and capital markets.

We support the publication of the paper and encourage the staff to proactively seek the views of the private sector on the proposed framework so that to move both sides closer to the achievement of a common goal of a collaborative debt restructuring.

Mr. Yagi and Mr. Miyoshi submitted the following statement:

Key Points:

Improving clarity in the restructuring process would contribute greatly to promoting dialogue between debtor countries and their creditors, as well as clarifying and making more accountable Fund policy on lending into arrears. The proposed general principles and best practices of an organized negotiation framework are basically appropriate.

It is also necessary to ensure flexibility in judging whether or not a debtor country is making good faith efforts, taking into account the diversity in its investor base, its type of debt, as well as its scale of restructuring. The Fund must avoid rigidity in operating this policy with disregard for specific circumstances.

The Fund's policy on lending into arrears must not impair market discipline. It must be made operational in a manner that would not cause moral hazard in both debtor countries and their creditors, and that would not have an adverse effect on the preservation of Fund resources. Lending into arrears requires rigorous debt sustainability assessments and continued monitoring of negotiations on debt restructuring.

We thank staff for providing us with an insightful paper on procedural aspects of the Fund's policy on lending into arrears to private creditors. The lack of clarity on the process of debt restructuring has amplified uncertainty, particularly about intercreditor equity on the creditors' side, and caused a stalemate in negotiations. Taking that into consideration, improving clarity would contribute significantly to promoting dialogue between debtor countries and their creditors, as well as to the whole process of debt restructuring. It would also bring about improved understanding and accountability to the Fund's policy on lending into arrears. The staff's approach to this issue is appropriate.

It is also necessary to ensure a degree of flexibility in judging whether or not a debtor country is making good faith efforts because, in the case of restructuring of sovereign bonds, the investor base and the type of bonds, as well as the scale of restructuring necessary, are diverse. The Fund must avoid being stringent in operating this policy with disregard for specific circumstances. This chair supports staff in this point as they clearly recognize the need for sufficient flexibility.

As is mentioned in the staff paper, the Fund's policy on lending into arrears must not impair the fundamental principles of market discipline, i.e., debtors must meet their debts in full and on time while creditors must bear the consequences of the risks they take. Lending into arrears is allowed only in exceptional cases in which financial assistance by the Fund is essential for the debtor country in implementing its adjustment policies and overcoming its economic difficulties, even if the restructuring of its debt has stalled due to various reasons. The Fund's lending into arrears must be made operational in a manner that would not cause moral hazard in either debtor countries or their creditors and that would not have an adverse effect on the preservation of Fund resources. This chair should emphasize that lending into arrears requires greater accountability that includes rigorous debt sustainability assessments and continued monitoring of negotiations between debtor countries and their creditors.

Since this chair broadly supports the thrust of the staff paper, it will make brief comments following the issues for discussion.

General Principles of Dialogue

The three principles set out in the staff paper to achieve broad creditor participation and efficient operation of capital markets, that is, (i) engaging in early dialogue, (ii) sharing information in a timely manner, and (iii) providing creditors with an early opportunity to give input on restructuring strategies, are appropriate. Particularly, it is important from the viewpoint of creditors that the third principle is well observed. At the same time, however, the application of the principles should be sufficiently flexible so that the Fund can provide financial assistance appropriately.

Modalities of Dialogue and Judgements on the Appropriateness of Using Organized Negotiation Framework

In judging whether dialogue and negotiation should be done in an organized negotiation framework or may be done informally, specific circumstances should be carefully considered, such as the types of bonds in question, the investor base, the scale of restructuring, and whether or not the debtor country is in default. Generally speaking, organized negotiation would be desirable in cases where investors are diverse and where the debt situation is complex, as staff points out. However, it would be difficult to draw a clear line between the two.

In this sense, we agree with staff that among the three approaches for clarifying the content of the good faith criterion that has been presented in Section IV. A in the staff paper, the third approach would be most appropriate. On one hand, the second approach, in which a good faith debtor is presumed to invite creditors to participate in an organized negotiation framework, would be too rigid as there are cases in which the investor base is so narrow that the objectives of dialogue could be achieved through highly informal consultations. On the other hand, the first approach, in which no criteria are provided, would give too much discretion to debtor countries and the creditors' concern about the uncertainty regarding the process of debt restructuring would not be reduced.

It should be noted, however, that the third approach would leave substantial room for discretion to the Fund in judging whether or not the debtor is making efforts in good faith, as no presumption would be established by appearance. Therefore, greater accountability would be needed in decisions made by the Fund on lending into arrears.

Best Practices of Organized Negotiation Framework and Evaluation by the Fund

The best practices of organized negotiation framework that are presented by the Fund are broadly appropriate, but sufficient flexibility would be required in individual cases when the Fund judges whether or not the debtor country is making good faith efforts. For example, it is arguable that standstill on litigation during the negotiation process can be achieved in the absence of collective action clauses, as the investor base of sovereign bonds could be extremely broad. Although the Fund's adoption of standstill on litigation as best practice would provide incentives for introducing collective action clauses in the contracts of sovereign bonds, the Fund should be flexible in applying this principle at this stage.

As staff rightly points out, it would not be desirable to establish a numerical threshold in assessing whether a steering committee of creditors is sufficiently representative, and the assessment should be made on a case–by–case basis, taking into account such factors as the characteristics of bond holders. Likewise, due attention should be paid to investor base of debts and specific efforts by the debtor country in assessing whether a reasonable period had elapsed to allow for the formation of a representative committee. Setting a 90–day threshold for establishing a committee or establishing a presumption that debtors would enter into good faith negotiations with a representative committee, as proposed by staff, could lead to rigidity in the application of the good faith criterion.

Mr. Portugal submitted the following statement:

The clarification of the good faith clause in the lending into arrears policy should help the Fund to promote effective balance of payments adjustment, while providing adequate safeguards for the use of its resources. The clarification of the good faith criterion should reduce the leverage of both creditors and debtors, thereby paving the way for a constructive and timely dialogue to be established regarding a restructuring process.

The 1998/1999 modifications of the Fund's policy on lending into arrears were an adaptation of existing policies to changing circumstances, in particular, the growing reliance on international sovereign bonds as the major channel of external financing to emerging markets in the 1990s. Encompassing international sovereign bonds within the scope of the policy of lending into arrears responded to these changing circumstances. Nonetheless, Directors agreed that such a policy would be implemented in a case-by-case basis taking into account that prompt Fund support was essential for the successful implementation of policy adjustment; that negotiations between the sovereign and its private creditors had begun; and that there were firm indications that the sovereign borrower and its private creditors would negotiate in good faith on a debt restructuring plan. Given concerns related to the specificities of restructuring bonds, that may have precluded the Fund from lending even if the member's adjustment was appropriate and financial support was essential, led the Fund to introduce a test based upon an assessment of whether the member was making good faith efforts to reach agreement with its creditors.

As the staff points out, the experience with bond restructurings since 1999 indicates that the alleged difficulties to identify bondholders and coordinate meetings with creditors are not as severe as previously thought. Nonetheless, it may be reasonable to expect that in complex cases with a variety of instruments under restructuring and with a widespread basis of bondholders, the restructuring process can be quite difficult and protracted. In any case, the idiosyncrasies of each event caution in the direction of allowing sufficient flexibility for the sovereign and its private creditors to workout the restructuring in a way that helps to preserve the value of assets, while being consistent with the overall capacity of the sovereign to face the new financing requirements.

The paper provides a number of principles for a constructive dialogue between debtors and their creditors to be considered when the Fund assesses the good faith effort being made by the parties in a restructuring process. We share the view that a member country should be expected to initiate a dialogue with its creditors prior to an agreement on a Fund-supported program. As to the principles to be followed during this dialogue, we concur with the proposal outlined in section III-A, with the exception of the provision of a comprehensive picture of the treatment of all domestic and external claims—part of the second bullet in paragraph 23. The implication of this bullet is that a case of debt restructuring will, by definition, include the sovereign's domestic debt, which is, to say the least, a very controversial issue, that this chair strongly opposes.

Regarding the suggested features of an organized negotiating framework, as proposed in paragraph 19, we are not convinced of the necessity to establish ex–ante that the debtor should share confidential information with the steering committee. While we recognize that, in some situations, the sharing of confidential information may be relevant and necessary for creditors to make informed decisions regarding the terms of restructuring, the decision to share this type of information should be left at the debtors' discretion and not be part of a best practices guide. We are not convinced also that every member with an alleged complex debt restructuring case should be obliged to follow an organized negotiating framework. We still think that flexibility is of the essence to facilitate the restructuring process. We are unconvinced that such an organized framework would calm markets and limit capital flight and withdrawal of external financing. We are also mindful of the debtors' concerns that the requirement to follow such an organized framework could unduly prolong the restructuring process.

While we acknowledge the existence of potential benefits from adopting an organized framework, we sustain that flexibility concerning the requirements for establishing "good faith efforts" between a member and its creditors should be fully exercised. This means that we support the first approach outlined in paragraph 38. This approach, however, should not be considered as leaving the existing policies unchanged, as suggested by staff, since the principles proposed under section III–A, with the proviso presented above (our paragraph 4), could be applied to assess "good faith efforts".

Finally, we concur with staff's view (expressed in paragraph 52) regarding the provision, by creditors, of inputs on the dimension of the financing parameters that will impact the design of the Fund program.

Mr. Bischofberger made the following statement:

We welcome today's opportunity to discuss the Fund's lending into arrears policy. The Staff paper is indeed very timely, considering our evolving discussion on debt issues. Also, the current developments in Argentina underline the importance of clarifying this policy tool. Staff's balanced and carefully crafted paper provides, in our view, a good basis for achieving this goal. I can thus be reasonably brief in my further remarks.

As I indicated in this morning's discussion on the SDRM, we see the policy on lending into arrears as part of a comprehensive and coherent international framework for crisis prevention and resolution, complementary to the other elements, including the SDRM, PSI, and access policy. Lending into arrears, under exceptional circumstances, helps to keep up the pressure on creditors and debtors to reach a debt restructuring agreement. It thereby support crisis resolution and PSI.

However, like Mr. Yagi and Mr. Bennett, I would stress the need to preserve market discipline, and to establish the right incentives for debtors and creditors. A clarification of the "good faith"-criterion, as elaborated in the Staff paper, is clearly important in this regard. In addition, individual decisions to lend into arrears must be explained in detail in appropriate documentation, including a rigorous debt sustainability analysis, and a balanced account of debtor-creditor negotiations.

As for the "good faith"-criterion, I fully agree that more clarity is called for, in order to make debt restructuring negotiations more effective, and to raise the acceptability of the framework among private creditors. At the same time, I agree that the criterion must be applied in a flexible manner, to allow for the possibility of very different circumstances in each case with regard to investor base, type of debt instruments, etc.

As regards the proposed principles of dialogue between a debtor and its private creditors, as well as the supplementary principles for negotiations in an organized framework, these appear to be generally reasonable in our view. The key task will be to communicate them appropriately, and to apply them in a stringent manner. This does not preclude some degree of flexibility in the case of the supplementary principles. For instance, the use of subcommittees may be helpful in certain complex cases, but, at the same time, too much fragmentation of the negotiations will likely obstruct efforts to reach a rapid solution. As to temporary standstills on litigation, we have sympathy for including such a principle in the framework.

On the three alternative proposals for applying the good faith-criterion, we concur with Staff that the third approach presents a reasonable balance between the two objectives of flexibility and predictability. It will be important to choose between an organized or a less structured negotiation format in a consistent manner, on the basis of the proposed criteria. We broadly support Staff's proposals to this end, including the exercise of judgment in such questions as whether a creditor committee is sufficiently representative.

Mr. Wei made the following statement:

At the outset, we thank Ms. Krueger for her informative statement and staff for the comprehensive paper. The policy on lending into arrears is an important tool for preventing further economic dislocation during a crisis and is closely linked to our discussion on establishing a feasible framework for restructuring sovereign debt. Like the SDRM, the policy on lending into arrears relies heavily on the incentive structure. In this sense, we need to strike a balance between promoting a rapid debt restructuring agreement and respecting the debtor's authorities in terms of their decision making on debt issues.

We generally support the framework proposed by staff in the paper. The extension of the coverage of debt instruments has made the policy more compatible with the development of the international capital market. The introduction of the Good Faith Criterion has made the condition on lending into arrears less rigid and facilitated the Fund's effort to prevent economic dislocation of member countries. While we support the introduction of the Good Faith Criterion, its judgment could sometimes be difficult. In this regard, we associate ourselves with Mr. Yagi's view that the Fund must avoid rigidity in making a judgment on whether or not a debtor country is making efforts in good faith. The specific circumstances of the debtor country must be taken into account when making such a judgment. Comparing the three approaches laid out by staff for the assessment of good faith efforts, we are generally comfortable with the first approach as we feel that it is more balanced than the other two approaches. The second approach lacks flexibility, and the third seems to have given the creditors too much leverage. Furthermore, we support assessments being conducted in a flexible way given the diverse conditions of member countries. We appreciate the view that once the negotiations are stalled due to a creditor's request being inconsistent with the Fund–supported program, the Fund should continue to support the member notwithstanding the lack of progress in negotiations. Also, it is important not to give private creditors a veto over the design of the economic adjustment program.

During the discussions on the statutory approach to the SDRM, staff laid out their proposed strategies to facilitate the negotiation on debt restructuring. We would like staff to elaborate further on how to reconcile these proposals with those stated in the paper. As said above, the incentive structure is of key importance. The Fund should pay more attention to the prevention of economic dislocation and encouraging new lending to the debtor.

Ms. Lundsager made the following statement:

We welcome the staff's and management's response, embodied in the paper under discussion today, to the international community's call for clarification of the Fund's policy of lending into arrears to private creditors. There is scope for a more refined policy and greater clarity about how the Fund would determine that a sovereign is engaging in "good faith efforts to reach a collaborative agreement with creditors." However, the Fund should not insert itself too deeply in a process that should be driven by the debtor and its private creditors. We agree very strongly with the staff that the policy should remain sufficiently flexible to enable the Fund to fulfill its core mandate—which is to provide timely assistance to members that are implementing sound adjustment policies.

We recognize that it would be helpful to reduce, to the extent possible, market uncertainty about the Fund's lending into arrears policy. We also understand that many market participants feel strongly that the Fund should use its ability to lend into arrears to encourage a sovereign to interact with its creditors. We agree that an early ongoing dialogue between a sovereign and its private creditors should be encouraged by the official sector. Thus, we can support elements of the staff's favored approach for clarifying existing policy. Helpfully, that approach would establish three general principles for dialogue between a sovereign and its private external creditors in the context of elaborating restructuring proposals but leave the modalities of dialogue open. It also calls for a more formalized assessment of these efforts by the Board.

Importantly, the approach preserves the need for the Fund to consider each decision on lending into arrears on a case-by-case basis. It also recognizes that debtors may fulfill the policy's requirement for sovereigns to engage in "good faith efforts to reach a collaborative agreement with creditors" in various ways and preserves Board flexibility in interpreting those efforts. However, the Fund's proposed approach can be improved.

First, we believe the approach should incorporate more explicitly the idea that the "guideposts" for determining whether a debtor is engaging in good faith should be implemented flexibly. Each case will present its own complexities as the current situation in Argentina demonstrates. Further, as the paper notes, delays in reaching agreement between a debtor and its creditors may not reflect lack of good faith but rather the uncertain economic environment. A country likely needs a credible macro adjustment plan before a reasonable determination can be made about its capacity to repay its creditors. Any application of the "guideposts" must consider this.

Second, certain proposals to make the approach operational give us cause for concern. The Fund should avoid making judgments about the desirability of using a collective negotiating framework. The staff acknowledges that the modalities of dialogue between a debtor and creditors likely will differ depending on various factors, including the number of creditors involved, whether the debtor is seeking to restructure prior to a default, and whether the creditors have organized themselves into a representative committee.

In short, the decision to form a creditor's committee should rest with the creditors. While it may be appropriate for the Fund to assess good faith by determining whether the debtor is communicating with its creditors, it is essential for creditors to retain the flexibility to organize or not organize. And, in the cases when a creditors' committee has been organized, the Fund should not prescribe procedures for interaction between a debtor and a creditors' committee.

Third, we note that many of the actions or the end results sought through the application of the staff's preferred approach could also be encouraged through use of certain contractual provisions. Work is underway in order to develop model clauses that would encourage greater debtor and creditor dialogue, among other things. We would suggest that whether a country uses clauses should be a factor in the consideration of whether to lend to countries in arrears to private creditors.

Finally, although, we agree generally that early dialogue should be encouraged, the specific timing of a debtor's initiation of dialogue with its creditors relative to approval of a Fund arrangement would need to be assessed on a case–by–case basis. Also, we believe that creditors' committee input into the development of a Fund program could be acceptable, but it would be inappropriate for the private creditors to have the power to control or veto the components of a Fund program.

Mr. Padoan made the following statement:

We welcome this paper, that offers useful steps forward on a key aspect of the Fund's policy. The effectiveness of the proposed approach must be evaluated in a broader context, keeping in mind the other elements of a framework for crisis prevention and resolution, including the role of Debt Sustainability Analysis, Access policy, and progress toward the SDRM.

Indeed, having in place a framework and a procedure for debtor creditor negotiations would add to the effectiveness of the overall crisis resolution policy by contributing, inter alia, to minimize collective action problems. Symmetrically, a clear procedure for access policy and, in perspective, an effective SDRM, would reinforce creditor debtor interactions.

It is encouraging to note, in this respect, that market participants, especially segments close to the dedicated investor end of the spectrum, would view favorably such a framework. This suggests that, sometimes, fears that better organized markets would increase the cost of credit and decrease the efficiency of market activities, are misplaced.

On the choice of the approach we share staff' view that the third approach would offer the best solution in the trade off between flexibility and clarity.

Of course, the effectiveness of the framework will have to be tested in the field, and on a case by case basis. In the meantime exchange of views with creditors and experience from ongoing cases will add to our understanding of the working of the mechanism.

That said, I would like to add a few comments on one issue, signaled in the paper which deserves further scrutiny: the possibility that, where the debtor engages in a dialogue with creditors prior to the approval of a Fund supported program, creditors may seek to influence the dimension of the financing parameters.

Of course, it is essential that, in a framework of lending into arrears and in crisis resolution in general, the Fund fully maintain its freedom of action while remaining open to a dialogue with creditors. However, this may be more difficult to obtain in practice. De facto, in the case in which a Fund supported program has not yet been approved and the debtor engages in a dialogue with creditors, two negotiating tables would be operating simultaneously. These two tables would be inevitably interrelated and debtors, and not only creditors, would try to exploit the linkages to their advantage. It is hard to rule out completely the risk for the Fund to loose its leadership and fall captive to the other parties.

I have no solutions to this problem and I would certainly like to hear Staff views. Let me add one point however. One way the Fund can maintain its leadership is by making the best use of its assessment of debt sustainability. A clear, convincing, and independent assessment of Debt Sustainability would provide the framework for program design, the appropriate combination of adjustment and financing, and the benchmark for creditors and debtors in their negotiations.

Allowing creditors to interfere with this assessment through the indication of financial parameters would not only weaken the Fund's leadership in the process but undermine the effectiveness of the whole crisis resolution mechanism.

Since the devil is in the details let me add another specific point. Precisely because there is a risk involved in the two negotiations going on, preserving confidentiality would be of the utmost importance. The paper discusses some of the possible measures to this purpose including the role of "professional advisors". Do we have any evidence on the effectiveness of this and other measures to insure confidentiality in debt negotiations?

Mr. Brooke made the following statement:

As others have noted, the conditions under which the Fund is prepared to lend into arrears affects the incentives for debtors and creditors as well as perceptions of inter–creditor equity. We agree therefore that it is important to clarify these conditions and the way in which the Fund reaches its decisions that a debtor is making a good faith effort to engage with its creditors.

We concur with the general principles that should guide dialogue between debtors and creditors set out on p10 that debtors should engage early with creditors, should share relevant information including a comprehensive picture of all domestic and external claims, and should give creditors an early opportunity to give input on the design of restructuring strategies. We also concur with Mr. Bennett that the provision of information should be timely and that inter-creditor equity should be ensured. To help achieve inter-creditor equity I would be interested to hear from staff whether it would be useful to add to the list of principles a presumption that payments are suspended on all debts, with some appropriate exclusions, so that arrears are accumulated on a non–selective basis; and a presumption that the sovereign makes no side payments on a selective basis.

On debtor consultation with creditor committees, we agree that the third approach. The fact that the debtor is expected to negotiate with a sufficiently representative committee of creditors should help to provide stronger incentives for creditors to organize themselves into representative bodies. As noted by others the incentives here would be further boosted by progress on CACs which is why we continue to advocate their more universal inclusion in bond contracts.

Where a representative creditor committee is in place, we think staff should also consider in consultation with sovereign debtors whether there is more that the debtor can do to address creditor concerns about a lack of cope for private creditors to contribute to decisions on the appropriate scale of the write down. We think it would be helpful for debtors to engage representatives of the creditor committee at an early stage and to increase the exchanges of information. As Mr. Padoan has highlighted, over time, we hope that regular inclusion of debt sustainability analysis in program documents will help raise the quality of debate about sustainability and the evolution of the financing gap between the private sector and the official sector. This should also help promote greater pricing discrimination.

We also strongly support Mr. Bennett that one way to help address creditors' concerns is by mandatory publication of the Fund's justification of decisions on lending into arrears—and we also think that this would be helpful from a prudential perspective. Furthermore, putting this policy into operation will require a great deal of judgment on the part of the Fund (as others have noted), and so it would be helpful to be transparent about the evidence supporting that judgment. Finally in making the approach operation, we hope that maximum flexibility will be given for the debtor and creditors to organize themselves —with the Fund adopting a light approach (that avoids the possible perception of micro–management of procedure).

Mr. Kiekens made the following statement:

In principle the Fund only supports countries that have no arrears to their external creditors, be they public or private, banks or bondholders. Several exceptions have been accepted to this so-called "non-tolerance of arrears." The Fund can grant an arrangement if it has sufficient assurances that soon after the its approval by the Board, Paris Club creditors will agree with a new scheduling of their claims which is compatible with filing the financing gap.

As described in the staff paper, the Fund has also accepted, since 1989, arrears owed to a country's commercial bank creditors if a) early Fund support is essential; b) restructuring negotiations have already begun; and c) a rescheduling agreement consistent with balance of payments viability can be expected within a reasonable time period. In 1998/99, the Fund extended this "lending into arrears" to include bondholders as well. However, the third of the above conditions has been altered. The Fund must now find that the country is making "good faith efforts to reach agreement with its creditors."

It is time to further clarify the "good faith efforts" criterion. The Fund may soon have to lend to Argentina under its new lending-into-arrears policy. Such a clarification will guide the negotiations between the country and its creditors.

In considering the good faith efforts of a debtor country, one should distinguish between the procedural aspects and the content of the negotiations.

The staff paper deals rather extensively with procedural issues. Similar topics were discussed on an earlier occasion on January 24, 2001, when the Board considered a proposal of the Council of Foreign Relations on "Principles for a cooperative Framework for Negotiations Between Sovereign Debtors and their Creditors."

I broadly agree with the two primary objectives of the dialog between a sovereign debtor and its external private creditors, as formulated by the staff. The participation of creditors should be broadly based to help solve the difficult issues of inter-creditor equity. The negotiation process should be predictable to reduce market uncertainty and its adverse effect on the value of claims. I agree that a) the dialog should begin early; b) that the country should share relevant non-confidential information with all its creditors on a timely basis; and c) that the creditors should have an early opportunity to contribute to the design of the restructuring.

The staff makes further sensible proposals, in paragraphs 28 and 29 of this paper, on how a country should behave in case its creditors are able to organize representative committees. I agree that the organization of such committees has implications for both creditors and debtors, as described in paragraphs 31 and 32.

I would like to offer a few thoughts on the subject of creditor representation.

The staff suggests that judgments about whether a committee is sufficiently representative should be based on the share of the principal held by those creditors who support it, as well as its coverage of the major classes of creditors. The staff does not find it advisable to set a hard and fast numerical criterion for judging whether or not a committee is representative. I think that a numerical threshold can be useful, if applied flexibly, together with other factors. However, when drafting collective actions clauses (CACs) a hard numerical threshold must be set for determining the needed qualified majority.

The staff observes that a creditor committee may have no power to make decisions that are binding on all creditors. That is true enough, but I would like to observe that a qualified majority of creditors may well have the power to take decision that bind all creditors, for instance if the creditor committee has been established by CAC or under a prospective SDRM.

I would now like to comment on the criterion of good faith in terms of substantive progress rather than conformity to procedure.

Obviously a major issue to settle will be the specificities of a restructuring and the sharing of the burden among various creditor classes. Difficult as these topics may be, the most substantial issue will be the size of the debt relief when a country has serious solvency problems. How large a reduction in the net present value of creditors' claims is needed? A delicate balance must be struck between preserving the growth capacity of the debtor's economy—and thus its capacity to pay over time—and creditors' legitimate interests—or more precisely, rights—to be repaid. How much additional fiscal effort can be required from the debtor to repay its creditors even if this would reduce the debtor country's growth and per capita disposable income. How can the Fund judge that the country is making good faith proposals to its creditors with respect to this balance?

At first glance, this does not seem to be a major difficulty, which may be why the staff paper's treatment of this issue is rather cursory. By definition, a country will have agreed on an adjustment program with the Fund, including a macroeconomic framework, before it strikes a deal with its creditors. When the Fund lends into arrears, the country will have first agreed with the Fund on the size of its fiscal adjustment and thus the degree to which it can service its external public debt under reasonable expectations of access—if any—to domestic and external financing, including from multilateral and bilateral public creditors. The staff paper suggests that such an order of events is even desirable, because "in light of the incentives facing a debtor and its creditors ... it would be generally neither feasible nor desirable for agreement to be reached on a restructuring before there is clarity regarding medium-term prospects."

Once the country has reached agreement with the Fund, it should continue its dialog with its creditors to address investors' specific needs and resolve inter-creditor equity issues. But the staff also insists that any agreement with the creditors must fit the program parameters, which private creditors must not have the power to veto.

While I can agree with all of these assertions by the staff, some comments are in order.

By its decision to lend into arrears, the Fund considerably narrows the room for negotiations between a debtor country and its creditors aimed at deciding how much of the country's external debt should be serviced. The Fund must make such decision with the highest degree of impartiality. It must be careful to treat similar cases similarly. When making a decision of the fiscal effort to be required from a country the Fund must make a balanced judgment not about what is politically feasible in the debtor country, but what should be delivered. The degree to which a country can make fiscal efforts to service its external debt depends inter alia on its relative income per capita. Also, the Fund must be aware that by lending into arrears it is setting precedents which may influence the markets' expectations about when a country is likely to reach debt levels that the Fund considers too large for the country to service in full.

If we agree that the Fund will make impartial and wise judgments, disregarding its own interests as a preferred creditor, what reasonable room can be left for the debtor country and its creditors to negotiate about the size of the debt relief, once a Fund program for the arrears country has been agreed on?

It seems preferable, when lending into arrears, to agree only on a short-term program. This would allow the debtor and its creditors to negotiate a medium-term rescheduling that is compatible with the parameters of the short-term program and could require larger debt service in coming years, based on restored market access and a stronger fiscal effort than was initially agreed on with the Fund. But even in such circumstances, the Fund will have to make judgments on whether the medium-term debt service obligations are compatible with the financing parameters of later programs.

Moreover, creditors could provide part or all of the debt relief subject to review in light of later developments that would make things significantly better for the debtor than could be foreseen at the time of the negotiations.

Mr. Rouai made the following statement:

I agree that further clarification of the good faith criterion in the Fund's policy of lending into arrears, together with the design of a sovereign debt restructuring mechanism (SDRM) and the implementation of collective actions clauses (CACs), could lead to a constructive dialogue between debtors and their creditors and help to achieve orderly sovereign debt restructuring and improve the functioning of capital markets to the benefit of all parties. It is also important that any framework has enough flexibility so as to enable the Fund to provide timely assistance to members' adjustment program.

I share the thrust of the staff appraisal and wish to comment on the general principles and modalities of dialogues between debtors and creditors. I agree that a member country should initiate an early dialogue with its creditors prior to an agreement on a Fund-supported program. The principles identified by the staff in Section III-A are sensible, could lead to a more predictable restructuring process, and would help achieve a broader creditor participation.

With regard to modalities of the dialogue between debtors and creditors, I note staff's preference for the third approach as a balance between the need to promote the dialogue, while recognizing the diversity of individual country circumstances. Like Mr. Shaalan, we find that this approach relies heavily on the views and practices of the private sector. I share Mr. Callaghan's concerns regarding the manner in which this option will function. On balance, I tend to agree with Mr. Portugal and Mr. Shaalan that the adoption of the first approach, combined with the principles enunciated in Section III-A, will help to clarify the good faith clause in the Fund's policy of lending into arrears.

Mr. Zoccali and Mr. Costa made the following statement:

Staff has made a successful attempt to present, in an orderly fashion, the several factors bearing on the Fund's judgment regarding the "good faith efforts" undertaken by a member in need of debt restructuring to reach a collaborative agreement with its creditors. The concept of "good faith efforts" has become a key element of the Fund's lending into arrears policy. We welcome the flexibility introduced by staff, in their proposal in SM/02/248, to enable the Fund to fulfill its mandate of timely assistance to members, unhindered by a rigid procedural framework. A "one size fits all" approach in this regard would be clearly undesirable. At the same time, the proposal gives greater procedural clarity to the negotiations related to the restructuring of sovereign debt, thus meeting creditors' demand for a negotiating framework that may allow for a better pricing of risk of alternative restructuring strategies. Further elaboration of the consequences for debtors touched on at the end of paragraph 19, given the time-consuming nature and resource intensiveness of negotiating within an organized framework would have been useful.

The principles listed in paragraph 23 of the proposal are straightforward. These could all be subsumed in the need for a member restructuring its debt to engage its creditors early. The dialogue clearly should hover on the sharing of information, the policies implemented and the restructuring strategies. As highlighted by staff, close dialogue with private creditors is to be fostered even in tranquil times. In fact, this practice is normally followed by most emerging market countries with access to international capital markets and might be improved upon.

Regarding the modality of the dialogue between a debtor and its creditors, it is clear that what matters is to secure sufficiently broad creditor support for a restructuring strategy that will enable the debtor to regain access to capital markets and balance of payments viability. To achieve this may be more difficult than transpires from the staff paper, which implies that, as restructuring becomes more complex, given the range of instruments to be covered, a more formal collective negotiating framework would be desirable. The problem lies in that a complex restructuring also makes the "ex ante" definition of such formal a framework more difficult to achieve. Paragraph 29 of the report starts by referring to the principles that should guide the debtors and creditors in the negotiation when a representative committee of creditors has been established in a timely basis. Again these are straightforward principles, i.e. that creditors represented in the committee would agree to a standstill on litigation during the negotiation process or that debtors should bear the reasonable financial and legal costs of the steering committee. The real issues are not to be found in the principles, but rather in the fact that is highly unlikely that such a committee could be established on a timely basis in the case of a complex restructuring. Moreover, as mentioned in paragraph 31 of SM/02/248, "sovereign debtors have at times found it expedient to adopt a strategy that avoids negotiations with any organized group of creditors". In this regard, the advantages listed in paragraph 31, that could be derived from an organized negotiating framework vis-à-vis a more expeditious strategy used by some sovereign debtors is not entirely clear. Actually most of those advantages could be applied also to the expeditious approach. In the end, the litmus test to assess the benefits of either modality will be given by the degree of acceptance of creditors of the restructuring strategy being offered and how this may affect future ability of the debtors to tap resources from international capital markets.

The adaptation of the "good faith efforts" clause to changing circumstances and the third approach advanced by staff for clarifying this criterion is consistent with the need for flexibility that we consider essential. It would be to the benefit of all the parties concerned that creditors be able to organize a representative committee in timely fashion, as was done in the 1980s, and for debtors to enter into good faith negotiations according to the principles listed by staff. On the other hand, if such a committee is not established within a reasonable period of time, a less structured form of dialogue would be called for.

To make the third approach operational the staff list four aspects. As we have already mentioned, the first relating to the complexity of the case may be deemed the more controversial. In this regard, while greater complexity may make the case for an organized framework more compelling, the difficulties to achieve it are also larger, particularly when the third aspect—the time period required for the formation of the committee—is factored into the analysis. The second aspect, that of assessing whether a committee is sufficiently representative by looking at the proportion of principal represented by the committee is a more straightforward proposition. We agree also with the fourth aspect that in case of a creditor committee exists the member should be making good faith efforts to enter into a meaningful dialogue with such a committee.

Finally, regarding the timing of the dialogue with creditors, particularly during the period prior to the approval of a Fund arrangement, we are of the view that private creditors, should be apprised of the progress on program negotiations and even express their views, they should not have, however, a veto power over the design of the program. Moreover, in those cases where restructuring terms proposed by creditors are inconsistent with the financing parameters of the Fund-supported program, the Fund should continue its support despite a prolongation of the debt restructuring negotiations.

After adjourning at 12:55 p.m., the Board reconvened at 2:30 p.m.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to questions and comments from Executive Directors, made the following statement:

First, one question from Mr. Callaghan and one from Mr. Wei about the relationship between the lending into arrears policy and the SDRM. When the SDRM is in place, it will have some implications for lending into arrears policy, but the two are no sense contradictory. We do not see that the principles involved in the negotiation would be much different whether the SDRM existed or not. The main difference is that, once negotiations are under way, we would hope under the SDRM framework, to move quickly to negotiations between the debtor member and its creditors, so we would be applying the principles on how to conduct those negotiations. We hope to reach that situation rather earlier than under the current arrangements.

Mr. Callaghan asked whether automatically the member would be deemed to be operating in good faith if it invoked the SDRM and was conducting its discussions within that framework. The SDRM itself provides a mechanism for the creditors to indicate that they do not think the debtor is acting in good faith; they can at various points terminate the protection given under the SDRM if they think the member is not acting in good faith. However, that does not mean that the Fund Board would necessarily make the same decision. The Fund Board would have its own criteria, which is what we discuss here in the paper, about whether the member was indeed operating in good faith. It would not rely on the judgment of the creditors. Of course, the actions of the creditors and the way they express their views would be an element which would feed into the decision of this Board. So, there is no contradiction here: the policy we are proposing is quite independent of what is being proposed on the SDRM.

Another question raised by Mr. Brooke was a possible addition to one of the principles, whether there should be a presumption that any suspension of payments should be nondiscriminatory between creditors. This is difficult. Even in the lending into arrears scenario, Fund policy is not to tolerate arrears to official creditors. So, the relevant nondiscrimination would presumably be between private creditors. There will still be a number of forms of credit which may make sense, both from the member's and from the other creditors' point of view, to continue to service. So there may some forms of credit on which would not be advisable to suspend payments. There may also be cases where it is one particular debt instrument which is causing a huge hump in payments. It is not obvious that in those circumstances the member should suspend payments on all its sovereign debt, rather than just on the one instrument which needs to be restructured in order to resolve the problem. So, we would not propose adding in a broad principle of nondiscrimination. There may be a the problem of discrimination if the debtor makes side payments to certain creditors within a given instrument, but that would require further consideration.

Finally, there was a question raised by Mr. Mozhin about the operational implications of this for the presentation of lending into arrears cases by the staff to the Board. We intend to evaluate the member's relations with its creditors and discuss what the member was doing with its creditors, in the event that the Fund lends into arrears, and to do so in light of the principles that we would hope the Board would endorse here. So, the idea would be to discuss these issues, leaving, of course, the judgment on good faith to the Board.

The staff representative from the Policy Development and Review Department (Mr. Fisher), in addressing Ms. Lundsager's point on creditor committees, remarked that the staff had envisaged that there would be no role for the Fund in the formation of the committee. Confronted with a situation in which their claims needed to be restructured, creditors may or may not elect to form committees. It was the staff's expectation that, in the more complicated cases, creditors would put the effort into doing so. In the simpler ones, they probably would not. Such a decision would be a matter solely for the creditors to make. In the event the creditors did form a reasonably representative committee, it seemed likely that in order to get an agreement with these creditors, the debtor would have to deal with that committee.

What the staff had suggested, therefore, was that in such circumstances where there was a reasonably representative committee and where it was warranted by complexity—and the staff had suggested some criteria for that—there was something of an expectation that the member would deal with that committee, the staff representative continued. This would not be a requirement, as it would not be part of formal conditionality. Rather, it would create an expectation that, in that environment, in order to finalize any deal that would provide the financing assurances and lay the basis for the country's return to sustainability, that such a committee would need to be dealt with.

The staff representative from the Legal Department (Mr. Hagan), in response to the question on issues relating to confidentiality and to what extent there was precedent that could provide useful guidance, remarked that the issue was difficult to address. In part, this was because during the debt restructurings of the 1980s the confidentiality of information in the Steering Committee had been, in part, safeguarded by the fact that these institutions were relatively large and had so-called Chinese walls among their various operating departments. In circumstances where the creditors in question were relatively small hedge funds, where the person who was the trader may in fact also be on the committee, there was a concern as to whether the creditors may, in fact, be either not complying with the confidentiality requirement or, even worse, be trading on the basis of confidential information. Such a problem was not unique to the sovereign context; it also had arisen in the nonsovereign context, as there was also the same diversification of creditors. Techniques had been developed to address the problem. One was for a creditor group—for example, on a bond issuance—to ask a professional who was not a creditor to sit on the committee, and the professional would essentially be responsible for receiving the information, and forming a judgment as to whether it would recommend to the creditor group that it represented to either accept or reject the proposal. However, it would not disclose that information to the creditor group. In other words, a kind of Chinese wall would be constructed around that professional. Such a mechanism had been used in the nonsovereign context and could be used in the sovereign context.

Ms. Lundsager thanked the staff for clarifying that negotiating with a creditor committee was not a requirement. It was important to maintain the flexibility to consider all aspects of a problem—including unforeseen possibilities—think about the debtor's side as well as the creditors' side, and not have an automatic presumption that a committee was the only way of dealing with the matter.

Mr. Duquesne made the following statement:

> Like others, let me thank staff for this much–needed clarification of the so–called good faith clause. Such a clarification is all the more necessary as we progress on the road toward an SDRM. I would like, even if I just listened to Mr. Allen, to make a link between the two. Indeed, by accepting to lend fresh money to a debtor country in arrears with its creditors, the Fund will send a very strong and positive signal to the international community on the quality and candidness of the country's efforts to achieve a comprehensive restructuring of its debt in the future under the aegis of the SDRM.
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> Clearly, the issue at stake here is the balance of power between the debtor country and its creditors, and it is, as many say, a very delicate balance to strike, so that more predictability will not translate into more rigidity in the context marked by the extreme diversity and heterogeneity of country cases. In this perspective, we tend to support staff's preferred option of the third approach, as it preserves the flexibility of our current policy while instilling some general principles that will hopefully address some of the concerns expressed by the representatives of the private sector. Nevertheless, we should remain aware of the limits inherent in any such attempt, and this approach, of course, will still come down to making difficult judgments.
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> At this stage of the discussion, let me limit my intervention to two additional remarks. First, the impact of any change in our policy on the incentives of debtors and creditors should be carefully assessed. Indeed, the Fund's policy on lending into arrears should not impair the fundamental principles of market discipline and thereby cause moral hazard that would have an adverse effect on the preservation of the financial resources of the Fund. Like Mr. Bischofberger and others, we support Mr. Yagi and Mr. Miyoshi's emphasis that lending into arrears requires greater accountability that includes rigorous debt sustainability assessments and continued monitoring of negotiations between the debtor country and its creditors. This monitoring is indispensable to maintain a balance between the interest of the debtor country and those of its creditors. On the one hand, the Fund should maintain pressure on the debtor country by the threat of suspension of lending but, on the other hand, the Fund should also prevent some private creditors from breaking the negotiating process by expressing its support for the debtor country authorities when they implement some policies. Of course, some private creditors could also try to obtain financial conditions not consistent with the medium–term sustainability of the program.
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> Second, any clarification of our lending into arrears policy should be conditional on symmetrical progress made by the private sector. Let me be more explicit. As the staff's approach in the staff paper is to address private sector demand and has more predictability in Fund decision–making, private creditors should also improve their ability to organize themselves and

negotiate efficiently and rapidly with the debtor country. The inclusion of CACs in sovereign bonds is one clear venue for such a development, but it is not the only one. Other market–based formal procedures or the strengthening of professional organizations could also be envisaged, and this part of the balance should not be forgotten.

Mr. Nyambal made the following statement:

We welcome the opportunity to discuss the Fund policy on lending into arrears to private creditors. Like other speakers, we think that the Fund's policy on this matter must be sufficiently flexible to enable the Fund to fulfill its core mandate. Thus, while providing balance of payments assistance to members that are implementing sound adjustment policies, we should avoid giving rise to moral hazard or create additional imbalances between debtors and creditors, as this might further weaken the credit culture and have an adverse impact on the ability of emerging markets to mobilize resources from private capital markets. In this context, we support the good faith effort criterion, as this would provide the Fund with the flexibility needed to exercise its judgment on a case–by–case basis.

We also support the principles put forward by the staff in order to promote a constructive dialogue between debtors and creditors. However, we share Mr. Portugal's reservation regarding the treatment of domestic debt. Although we understand the legal arguments used to give preferential treatment to external debt, we would like to call the attention of Directors on the fact that both domestic and external debt play a key role in the macroeconomic performance of a country. Therefore, we are hopeful that a pragmatic solution will be found for domestic debt in the context of the SDRM.

We concur with the staff that the establishment of an organized negotiating framework would facilitate the application of complex restructuring. On the one hand, we think that it could help debtors by calming market fears that could potentially lead to domestic capital flight. On the other hand, we are convinced that the impact of such a predictable restructuring process on creditors will depend on whether there are distressed debt purchases or not. The ultimate outcome on both sides will depend on whether there are mechanisms in place to prevent minority creditors from engaging in isolated litigations. As regards the management of the process, we agree with Mr. Portugal that the debtors should retain some discretion on how to share confidential information.

As regards the three approaches envisaged for clarifying the content of the good faith efforts criterion, Fund policy should provide sufficient flexibility in order to enable a diverse range of cases to be addressed. Since we advocate for more balanced relations between debtors and creditors, we are in favor of maintaining the first approach, as it gives considerable discretion in deciding the processes and scope of dialogue. Within the above mentioned framework, we welcome the opportunity for creditors to give input on the dimensions of the financing parameters that will impact the design of the program.

Mr. Andersen made the following statement:

Like others, I thank staff for a well-written report, bringing us a welcome step further in this area. As noted by Mr. Bischofberger, our policy on lending into arrears is an important element of the needed comprehensive crisis prevention and crisis resolution framework. With an improved transparent policy in this area, private sector involvement in the early stage of the restructuring should be promoted. Let me also join Mr. Padoan in his emphasis on the importance of a clear, independent, and comprehensive debt sustainability analysis, and underscore the importance of ensuring that the lending into arrears policy continues to be applied only in truly exceptional circumstances and, furthermore, that the primary responsibility for the negotiation on the restructuring procedures that lies on the sovereign and its creditors deserves emphasis. Here, I think Mr. Duquesne just made some important comments concerning the private creditors' responsibilities.

Regarding the specific issues in the report, I agree with staff that in any standstill or imminent restructuring, a candid dialogue in good faith between the sovereign and its creditors is crucial. Early contacts are imperative, as problems related to debt sustainability can easily start to escalate if the fall is believed to be imminent. It would therefore be expected that a member already has initiated a dialogue with its private creditors prior to the approval of a Fund program. Furthermore, it is important to underline that, even if discussions between a debtor country and its private creditors result in constructive input into program design, only the Fund itself should determine whether and how to commit funds of its own.

As regards the proposals for adapting the good faith clause, I concur with staff and other colleagues that the third approach in the staff paper is preferable, for many reasons which I shall not repeat. Let me just mention that since the modalities of an SDRM are still evolving and, if I may add, with very encouraging progress made in connection with our discussion earlier today, such an amendment of the Fund's policy on lending into arrears would be able to accommodate a broad range of cases while the proposed principles provide guidance which, in turn, will lead to more clarity of the process. I would also think that it would be worthwhile to consider, if I may make a connection to the contractual approach, making use of CACs a condition for financing where the Fund agrees to lend into arrears.

Finally, some important issues pertaining to the appropriate framework for lending into arrears are not touched upon in the document, and the staff does indeed mention this. For instance, more clarity as regards the circumstances when it may be necessary and desirable for a member to suspend payments to its creditors or pursue restructuring would be helpful in order to refine the crisis resolution process, as would more guidance on a number of issues related to the standstill period. I, for my part, would be pleased to discuss such other issues of relevance in the not too distant future.

Mr. Alosaimi made the following statement:

I fully agree with the staff and other speakers on the importance of dialogue and information sharing between creditors and debtors in not only crisis situations, but also in normal times. As this chair has noted in the past, continuous and close communications as well as exchange of information between debtors and creditors could play an important role in averting crisis or lessening its severity when a shock hits. Therefore, I agree that information sharing along the lines detailed in Section 3(a) could be useful. It is important, however, not to interpret those general principles rigidly.

Turning to the features and implications of an organized negotiating a framework, I agree that in some instances an organized negotiating framework could reduce the restructuring costs to both debtors and creditors. In other instances, a more informal approach may be preferable. Pending an agreement on the SDRM, however, it is important to leave the modalities of negotiations to the debtors and their creditors. Finally, the staff states in paragraph 31 that an organized negotiating framework could bring other advantages to debtors. However, those advantages were not clear from reading the bullet points in the paragraph. Staff comments would be appreciated.

Mr. Campos made the following statement:

Like other Directors, we thank staff for the comprehensive paper on lending into arrears to private creditors, and commend the efforts to clarify the good faith criterion. In particular, we welcome the framework of general principles and procedures outlined in Chapter 3 intended to guide the dialogue between debtors and their creditors in the context of elaborating proposals for the restructuring of sovereign debt to private creditors. Since we broadly support the thrust of the staff paper, we will make brief comments on some issues in discussion.

Overall, we see the process of clarifying the good faith clause as an important element that will help the Fund to promote effective balance of payments adjustment while providing adequate safeguards for the use of its resources. We also view the principles and procedures as appropriate guideposts for a constructive dialogue between debtors and creditors which, we concur, should start as early as possible. However, like other Directors, we are also of the view that the Fund should not participate directly into negotiations, leaving the process to be driven by the debtor itself. In addition, like staff and many Directors, we also believe that it is important that the Fund's lending into arrears policy remains sufficiently flexible to enable the Fund to provide timely balance of payments assistance to members in need that are implementing sound policies.

We also share Mr. Yagi's view that the Fund should ensure flexibility in judging whether debtor countries making good faith efforts take into account the diversity in its investor base, its type of debt and its scale of restructuring. In this regard, we endorse a case–by–case approach while applying the principles under the framework to the extent possible, as we consider indeed that such an approach should enable the Fund to address a diverse range of cases effectively. As Mr. Callaghan points out, and that we concur with, there is no one–size–fits–all prescription to the resolution of debt problems.

As regards the modalities of dialogue, we concur that informal mechanisms may be sufficient in some cases, while in others a more organized negotiating framework would be more appropriate. To this end, and like Mr. Shaalan and Mrs. Farid, and Mr. Portugal, we are also of the view that the first approach outlined in paragraph 38 seems to fit better the Fund's policy of flexibility. In addition, the principles set forth in Chapter 3(a) could indeed be applied to this approach to clarify good faith efforts. Nonetheless, we can support the adoption of the third approach as suggested by the staff, including the elements listed in paragraph 44, provided that during the process of assessing good faith efforts the Fund adopts permanently to all parties a fair approach, as stressed by Mr. Mozhin and Ms. Vtyurina. We concur with the publication of this paper.

Mr. Varela and Mr. Gonzalez–Sanchez made the following statement:

We welcome this opportunity to discuss the issue of the Good Faith Criterion in the context of lending into sovereign external payment arrears to private creditors. The Fund appropriately modified its policy on lending into arrears in 1998/1999 in order to adapt it to the new conditions, namely, the increasing reliance on international sovereign bonds as the main channel of external financing to emerging markets.

The staff paper presents a set of principles for the conduction of a constructive dialogue between debtors and creditors. This in turn would help to evaluate the good faith efforts being made by the parties involved. In this respect, we fully concur with the staff's opinion that the Fund's policy on lending into arrears should allow sufficient flexibility for debtors to engage in a constructive dialogue with its creditors. Establishing too strict ex–ante rules might be counterproductive. In this regard, we see merit in the first approach, indicated in paragraph 38, although we recognize that it may have some shortcomings, the main one being that the assessment on whether the debtor is making good faith efforts in its engagement with creditors should be based only on judgment, thus introducing an element of discretionary power that on the one hand is difficult to implement and, on the other, could lead to an uneven treatment among members.

Taking this into account, the third approach, outlined in paragraph 40, if less strictly defined, could provide better guidance for assessing the good faith efforts. The third approach as outlined by staff, rightly allows for ample room regarding the form of the dialogue between the debtor and its creditors. We agree that such a dialogue should be consistent with the principles expressed in Section III–A. It is important that the debtor starts an early dialogue with its creditors, and the debtor could benefit from inputs from creditors regarding the design of restructuring strategies and individual instruments. The suggestions and ideas of the creditors would enhance the prospects for reaching a solution better tailored for the specific circumstances of individual cases. Obviously, this should be considered as an input that could be taken into consideration by the debtor country, and not as a compulsory prescription that should be always followed. There should be substantial flexibility concerning the expectation that the debtor would engage in an early and continuous dialogue with its creditors and indeed there should not be the presumption that this would be the case. Also on the principles laid out in section III–A, we consider that the provision of a comprehensive picture of the treatment of all domestic and external claims on the sovereign should be modified, so that sovereign's domestic debt is not included in the framework.

In those cases where a creditors' representative committee has been formed, the staff proposal indicates that there will be an expectation that the debtor should enter into negotiations with this committee, in accordance with the principles outlined in Section III (C). Regarding the principles in this Section we have some reservations. On the one hand, it is doubtful that a collective framework should be established in order to conduct negotiations with the creditors, even if a creditors' representative committee has been set up. Such framework might prevent the needed flexibility, which we consider essential to facilitate the restructuring process, specially if we are dealing with a complex case of debt restructuring. This is something that needs further study and analysis by the Fund. In fact, the discussion of this matter is clearly linked to our ongoing analysis of SDRM and CAC issues which has not reached yet definite conclusions. On the other hand, it is not convincing that the debtor should share confidential information with the steering committee on a regular basis, although it might be justified in some situations.

Furthermore, we think that the third approach would be more operative and could get broader support, if instead of contemplating a presumed engagement of the debtor with the creditors' committee, it considers that good faith efforts towards such engagement is just a positive element or step in the negotiation process. Therefore, this third approach, if redefined in this way, would provide with sufficient flexibility so as to allow the Fund to judge on a case–by–case basis whether the engagement with the creditors' committee is justified and useful according to the country's specific circumstances.

The staff paper rightly points out that even if there are some rules that could guide the Fund assessment of the debtor's good faith efforts to enter into negotiations with its creditors, the final decision would always need to be based upon judgments. The elements that could be taken into account to make such judgments, mentioned in paragraph 44, are generally well taken.

Regarding the timing of dialogue with creditors, we support its initiation prior to the approval of a Fund arrangement. However, here again the debtor needs to have sufficient flexibility and room of maneuver in its negotiations with the creditors, provided that the principle of good faith efforts is preserved.

Mr. Yakusha made the following statement:

I welcome the proposal to further operationalize the good faith criterion. This chair, together with others, have for a long time asked for a clarification of our lending into arrears policy so as to adapt it to the changing circumstances in capital markets. In general, a country, of course, should try to avoid or quickly settle arrears prior to approaching the Fund for financial support. Our lending into arrears policy acknowledges that, although regretful, sovereign arrears can on occasion recur and, in that case, it may be necessary to set the rules for exceptions to the general principle and it is important that these rules be clear and effective, meaning that they lead to speedy resolution of financial crises.

I can find myself in general agreement with the staff and the views as expressed in the paper. I support the principle of relying more on an organized but flexible negotiating framework, this third approach. I support the best practices described in the paper to operationalize this approach. The only addition I have is that ideally a debtor should engage in a dialogue with its creditors before it is clear that restructuring is necessary, not just after. Like other Directors, I must admit, however, that the entire proposal struck me as a little abstract. I think the staff paper could have benefited from some more concrete country–specific examples.

For instance, it is not completely clear what, in adopting the third approach which seems to be getting support from the Board, would change in practice. Would countries be required to act very differently from how they have done thus far? Is it reasonable for us to expect them to adhere to best practices? I would, for instance, be interested to learn whether Argentina, for example, abides by the general principles that should guide the dialogue between the debtor and its private external creditors, as specified on page 10 of the paper. If it does not, would the adoption of the third approach imply that the Fund would not be allowed to lend to Argentina until it resolves its outstanding arrears? I would welcome any staff comments. Of course, I mentioned the example of Argentina only because it is the most obvious arrears case at this moment.

On another related point, it is crucial that the Board be informed of ongoing discussions between debtor countries and their creditors. You can only judge on the various operational aspects of the third approach if you receive frequent updates on the status of the discussions between the debtor and creditor.

Finally, I would be interested in learning more about the private sector response to the proposals. Could staff share with us some more details about the expected reaction from private sector representatives other than the capital markets consultative group mentioned in the paper?

Mr. Zurbrugg made the following statement:

In the context of a general endeavor to increase the transparency and public understanding of our various elements of the framework for crisis resolution, I very much agree with staff and other Directors that it would be beneficial to modify the lending into arrears policy once again and enhance the clarity of its main concept, namely the good faith effort.

As underscored by staff, assessing the good faith criterion contains a large judgmental element, and has caused different views on what exactly the Fund is pursuing in its policy. As long as the criterion was to be applied to both debtors and creditors, and negotiations had already started, which was the case under the 1989 and 1998 policies, the assessment would appear relatively straightforward. But, by eliminating creditor from the requirement in 1999, the judgment obviously became more complex.

I had some difficulty in assessing exactly how debtors had used or misused the new leverage they had received following the last policy change, but staff makes a strong case for rebalancing the playing field. However, I think we should be careful not to overshoot in the other direction. In my view, the third approach adequately takes into account this problem by allowing a certain degree of flexibility, depending on the characteristics of the case. However, the flip side of this flexibility is the necessity, once again, of making difficult judgment calls on important issues such as complexity of the case or quality of the creditor committee.

In the cases in which no creditor committee is deemed necessary, assessing the good faith element will continue to be very difficult. Adopting the general principles outlined in Section 3(a) in a less structured dialogue will pose significant problems, even if the case is less complex. In my view, experience could well show that not many cases will be captured in the framework without creditor committees. At this stage of the discussion, I only have two brief points that I would like to add, which I think have not been raised. One might seem minor.

I noted that in the principles outlined by staff for negotiations between debtors and creditors, they assume that the fees for financial advisors will continue to be borne by the debtor, as in the past. I wonder, as creditors have a significant interest in dealing with the debtor in a more structured framework, using creditor committees, if there were any scope in envisaging burden sharing of these costs.

The second point I have refers to a question raised by Mr. Bennett regarding the possible influence of large financial packages in lending into arrears cases. It is possible, even likely, that the abundance of official financing will distort incentives for both debtors and creditors so that the outcomes of restructuring negotiations could be more favorable for creditors than in the past. I wonder if staff has any comments on this issue.

Mr. Jayatissa made the following statement:

We thank the staff for producing a very useful and informative paper on the consideration of good faith criterion as part of the Fund's policy of lending into arrears. The paper and discussion of the lending into arrears policy is timely in the context that economic and market conditions have significantly changed during the recent past, with debt dynamics and sustainability issues becoming more critical in the design of Fund-supported programs.

Second, making possible improvements to the Fund's lending into arrears policy and to provide more timely assistance to countries involved will enhance the role of the Fund in crisis resolution. In this context, as staff has put forward the issues very clearly, we would limit our comments to some of the specific issues for discussion.

On the clarity in the judgment concerning the good faith approach, we are of the view that greater clarity in the judgment of good faith would be helpful, particularly to minimize the arbitrariness. I share the view expressed by some other Directors that greater clarity should not lead to high costs in terms of losing flexibility. On the principles for a constructive dialogue, we believe that all three principles laid out in the staff paper are useful to facilitate this dialogue. On the three approaches, we clearly see merits of the third approach, provided that the Fund staff and management use greater flexibility in their judgment about the progress made by the debtor to seek formal debt restructuring in the context of the availability of representative committees. We would wish to know what specific steps the Fund staff would propose the best judgment on this matter. With these brief comments, we basically would like to see a flexible approach.

Mr. Low made the following statement:

The issue before us appears quite straightforward in a way but, in its application, it is not as straightforward. What we are trying to do is to have some guidelines to assess whether a sovereign debtor is really engaging in dialogue with its creditors in good faith. To me, that is the crux of the matter. Three words that have been used by most, if not all, Directors perhaps sum up what our view is. The first is "judgment," second is "case by case," and third is "flexibility."

As many Directors have already emphasized, I think that it is not desirable, nor indeed, possible, to draw up rigid guidelines or, I think as Ms. Lundsager called it, guideposts, that debtors have to satisfy in order to meet this good faith criterion. Here, I echo what Mr. Callaghan has said that, ultimately, everything boils down to judgment.

While it is not possible to adopt a rigid approach, at the same time, we need to have some general guidelines, and I find those guidelines that were enumerated by staff in Section 3(a) to be sensible. I would assume that any debtor that wants to effectively restructure its debt would want to follow those principles. However, I am not sure whether that puts me in the camp of the first approach or the third approach; it is definitely not the second approach. Compared with the first approach, the third approach contains some additional guidelines relating to credit committees.

The third approach as elaborated in Section 3(c) contains some principles that are not the responsibility of the debtor; but of the creditor. For example, we talk about the creditor committee agreeing to a standstill. Not that I disagree with a standstill, but the question is, whether this responsibility of the creditors should be placed on a debtor in judging whether the debtor is engaging in a dialogue in good faith? I think the other issue that was raised was whether creditor committees are sufficiently representative. This is the responsibility of the creditor, not the debtor. So, I think some modifications to the third approach may be appropriate.

Allow me to one final comment on the suggestion raised by Mr. Bennett regarding the mandatory requirement for publication of the staff paper on assessing whether a debtor has acted in good faith. While I do understand the rationale for Mr. Bennett's suggestion, I think we have to approach this with more caution. It would be fine if the assessment or the judgment is that the debtor has acted in good faith, but what if it is the opposite? As I mentioned earlier, this is really a matter of judgment. Therefore, if we were to require publication of such an assessment, we could be precipitating a crisis instead of averting one.

The Deputy Director of the Policy Development and Review Department (Mr. Allen), in response to questions from Executive Directors, made the following statement:

Let me just take up a couple of questions. One was the relationship of the lending into arrears policy and access policy. This paper, of course, is dealing with a rather narrow issue as part of the lending into arrears policy, the application of the good faith test. It is not dealing more generally with access policy issues. The sort of cases where we are lending into arrears would not, prima facie, seem to be the cases where we would be providing exceptional access. At first sight, they would seem to be the cases where we are not providing large resources to ensure that the creditors get paid; on the contrary, we are lending money to a country precisely at a time when it is not paying its creditors, so they are being bailed in, if you like, in those cases.

The broader question is whether we are providing access at such levels that the member would be building up a war chest to pay off creditors, and so on. That is not the intention. The Board will be discussing access policy later this week. A case where we would be lending into arrears, one in which the member is restructuring its debt, would not be a case which one would expect it to pass the tests of either obvious debt sustainability or of rapid market reentry. So, there is no access policy issue here in the sense of providing resources to bail out creditors.

The other issue is the question raised by Mr. Yakusha about Argentina and the principle in paragraph 10. We are not at the point where we would be called upon to make this judgment. What paragraph 10 lays out is the sort of actions that we would expect any member in difficulty to be undertaking towards its creditors to facilitate a rapid agreement with them on a debt restructuring. So, when the time came, we would see how Argentina had met these various tests. Argentina has had contacts with its creditors, passing on information and having discussions, but the judgment on whether this accorded with the principles would have to be made when the time arises.

Mr. Yakusha asked whether the extension of repurchase expectation would affect the balance of power between creditors and debtors when negotiating any agreement.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) responded that the answer to that question would be difficult to ascertain.

The staff representative from the Policy Development and Review Department (Mr. Fisher), in response to questions from Executive Directors, made the following statement:

> The question was raised about the payments for fees for legal and financial advisors, and it was mentioned that this was the practice in the 1980s with the Bank Steering Committees. It is more generally the practice in workouts in the nonsovereign case. You quite frequently see committees being formed and the companies will always pick up the costs of these committees. Directors may have followed the recent case of Marconi, where there was a big reorganization of the company bondholders involved in that. It was, in fact, a sticking point in the formation of that committee, but eventually the company concluded it was in their interest to make the payment.
>
> The argument given is always that these fees in fact come out of the deal. In a sense, it is irrelevant who pays, because, if the country pays, then there is less money available to pay to creditors. So, at one level you could argue that it does not matter who pays. One argument we have heard frequently (but is somewhat more speculative in character) is that there is a compositional issue at play. If the debtor pays, then effectively the creditors are paying according to their exposure. If you force creditors to pay directly, those creditors who are willing to come up with the money are likely to be those who are more aggressive or litigious, because you find that the very large institutional investors simply do not have allocated to them resources for this type of workout. A crossover investor who may be involved in equities is not set up to provide their own restructuring departments and financing. So, at some level, it is in fact in the interest of the debtor to get a broad–based representative group of investors on the committee. The argument is speculative and, in case anyone asks, I cannot point to any empirical evidence. But it seems compelling.

Mr. Brooke wondered if the staff could comment on the general Board view that there needs to be more accountability in monitoring. Along with Mr. Bennett, he had gone much further than other Directors in suggesting a mandatory justification by the staff, which should be published, outlining the reasons for supporting lending into arrears based on the good faith criterion. There appeared to be broader support for greater monitoring and accountability so that the Board could be in a good position to judge whether the staff and management had made a correct decision. At the moment, the Board largely relied on the word of the staff and management and was not provided with additional information that could be the basis for an independent judgment. Perhaps the staff and management could consider providing the Board with more information on a regular basis on the status of arrears for all program countries.

Mr. Bennett clarified that he had suggested mandatory publication only of staff papers for which the Board had agreed to lend into arrears.

The Deputy Director of the Policy Development and Review Department (Mr. Allen) reiterated that the staff intended to document in a report how the member was implementing the good faith criterion, as the basis for the judgment. On the matter of providing continuous information about the status of a member's relations with its creditors when the Fund was lending to the member in arrears, it should be recalled that there existed the policy of financing reviews that, in the context of lending into arrears, the Fund requires periodic Board reviews on the financing assurances in the program, which includes the question of how the member was dealing with its creditors.

The Acting Chair made the following summing up:

> Directors agreed that the Fund's policy on lending into sovereign arrears to private creditors continues to provide a useful tool enabling the Fund to support a member's adjustment efforts before it has reached agreement with its private creditors on a debt restructuring. The pillars of this policy are first, that the timely support of the member's adjustment program is considered essential to help limit the scale of economic dislocation and preserve the economic value of investors' claims; and second, that the debtor engages its creditors in an early and constructive dialogue to help secure a reasonably timely and orderly agreement that would help the country regain external viability.
>
> Directors welcomed the opportunity to review the application of the criterion requiring a member to make good faith efforts to reach a collaborative agreement with its creditors, in light of the experience with bond restructurings since the introduction of the "good faith" criterion in 1999. They observed that this experience, although limited, suggests that notwithstanding the ability of debtors to reach restructuring agreements with their creditors, the restructuring processes have in some cases been protracted, reflecting the complexity of each individual case, as well as different perspectives and concerns among debtors and creditors.
>
> Against this backdrop, Directors agreed that greater clarity about the good faith dialogue between a debtor and its creditors during the restructuring process could help provide better guidance about the application of the lending into arrears policy and, more generally, promote a better framework for the engagement of debtors and creditors in the restructuring of sovereign debt. Greater clarity concerning the framework for possible debt restructuring would strengthen the capacity of investors to assess recovery values under alternative scenarios, thereby facilitating the pricing of risk and improving the functioning of the capital markets. At the same time, however, Directors stressed the need for continued flexibility in applying the "good faith" criterion to accommodate the characteristics of each specific case; to avoid

putting debtors at a disadvantage in the negotiations with creditors; and to avoid prolonged negotiations that could hamper the ability of the Fund to provide timely assistance. Indeed, any clarification of the "good faith" criterion should serve primarily to support the difficult judgments that will continue to have to be made in each case, and should be made operational in a manner that does not impair market discipline.

Directors considered that the following principles would strike an appropriate balance between clarity and flexibility in guiding the dialogue between debtors and their private external creditors.

First, when a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete.

Second, the member should share relevant, non-confidential information with all creditors on a timely basis, which would normally include:

- an explanation of the economic problems and financial circumstances that justify a debt restructuring;

- a briefing on the broad outlines of a viable economic program to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims; and

- the provision of a comprehensive picture of the proposed treatment of all claims on the sovereign, including those of official bilateral creditors, and the elaboration of the basis on which the debt restructuring would restore medium-term sustainability, bearing in mind that not all categories of claims may need to be restructured.

Third, the member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.

In discussing the various approaches that would best clarify the content of a member's good faith efforts in the context of the lending into arrears policy, Directors emphasized that the modalities guiding the debtor's dialogue with its creditors will need to be tailored to the specific features of each individual case. Most Directors considered that the third approach suggested in the staff paper for refining the good faith criterion provides an appropriate basis for the implementation of the Fund's policy, while retaining sufficient flexibility to address the diversity of individual situations. Although, as a general premise, the form of the dialogue would be left to the debtor and its creditors, under this approach a member in arrears would be expected to initiate a dialogue with its creditors prior to agreeing on a Fund-supported program consistent with the principles discussed above. In cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good faith negotiations with this committee, though the unique characteristics of each case would also be considered. This formal negotiating framework would include, inter alia, the sharing of confidential information needed to enable creditors to make informed decisions on the terms of a restructuring (subject to adequate safeguards), and the agreement to a standstill on litigation during the restructuring process by creditors represented in the committee. By the same token, in less complex cases, where creditors have not organized a representative committee within a reasonable period, or where for other reasons a formal negotiation framework would not be effective, the member would be expected to engage creditors through a less structured dialogue. Directors stressed that, in going forward with the suggested approach, it would be crucial to strike the appropriate balance between the need to promote effective communication between a debtor and its creditors, and the need to retain flexibility to address the diversity of individual country circumstances.

Directors discussed a variety of factors that would need to be considered in making the proposed framework operational. They emphasized that in assessing whether the member is making good faith efforts to negotiate, judgments would continue to be required in a number of important areas. These include a consideration of the complexity of the restructuring case, the extent to which a creditor committee is sufficiently representative, and whether a reasonable period has elapsed to allow for the formation of a representative committee. Directors viewed the considerations laid out in the staff paper as useful inputs for helping to make such judgments, which would need to be made flexibly. They also noted that to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameters that have been established under a Fund-supported program, the Fund should retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations with creditors. In this connection, it was stressed that decisions on an adequate macroeconomic framework that could form the basis for the Fund's lending into arrears will remain in the sole purview of the Fund.

Directors recognized that there may be circumstances where, following a default, the debtor enters into good faith discussions with creditors prior to the approval of a Fund arrangement. In these circumstances, creditors are likely to express views as to the appropriate dimensions of the program's adjustment and financing parameters. While such input would be welcome, Directors emphasized that it would be inappropriate for private creditors to be given a veto over the design of the financing plan or the design of the adjustment program.

All purchases made while a member has outstanding arrears to private creditors will continue to be subject to financing reviews, which will provide an opportunity for the Fund to monitor relations between a debtor and its creditors, and for the Board to be kept informed about developments in this area at an early stage. Going forward, a number of Directors also underscored the importance of strengthening debtor–creditor dialogue in good times, as this will provide a good base for advancing the required negotiation framework in times of stress.

3. WORLD ECONOMIC OUTLOOK (CONCLUSION)

Documents: World Economic Outlook—Prospects and Policy Issues (EBS/02/144, 8/9/02; Cor. 1, 8/22/02; Cor. 2, 8/28/02; and Sup. 1, 8/29/02); World Economic Outlook—Statistical Appendix (EBS/02/145, 8/12/02); and World Economic Outlook—Issues for Discussion, Boxes, and Appendices (EBS/02/149, 8/13/02; and Sup. 1, 8/28/02); see also Background Material on World Economic and Market Developments (WEMD) (EBD/02/132, 8/28/02)

Staff: Rogoff, RES; Robinson, RES; Bayoumi, RES

Length: 30 minutes

Executive Directors continued from EBM/02/91 (9/3/02) their discussion on the world economic outlook.

The Acting Chair made the following summing up:

Executive Directors noted that from the second quarter of 2002, economic and financial market developments have been mixed. They pointed to the negative developments on several fronts, including the sharp decline in global equity markets since end-March; the deterioration in financing conditions facing most emerging market borrowers—notably in Latin America; and weaknesses in a number of current and forward-looking indicators for the United States, Europe, and several other regions. These developments were especially disappointing against the backdrop of the strengthening of global economic indicators, including trade and industrial production, seen since end-2001, as well as first quarter growth that exceeded expectations in several regions.

Directors noted that the world economy and the financial markets have shown considerable resilience in the face of multiple recent shocks and that, going forward, several factors should support a steady strengthening in global growth—including the continuing stimulus from earlier macroeconomic easing in many regions, the winding down of inventory corrections, and the recent signs of greater stability returning to global financial markets. Nonetheless, Directors expressed concern that recent developments have raised questions about the strength and sustainability of the recovery, and agreed with the assessment that, overall, the outlook for the remainder of 2002 and for 2003 is likely to be weaker than had been anticipated in the April *World Economic Outlook*.

Directors assessed the risks to the short-term outlook as being predominantly on the downside. In particular, they noted that recent, and possibly further, equity price falls could have a more marked impact on domestic demand than currently expected—especially in the United States, which has led the global recovery to date. Directors noted that recent movements in major exchange rates are appropriate from a medium-term perspective, although in the short-term some negative impact on the recovery in Japan and the euro area, which has so far been led by external demand, should not be ruled out. Many Directors also saw the persistently high U.S. current account deficit and the still high U.S. dollar value as posing some risk of an abrupt and disruptive adjustment. Directors were also concerned that tight emerging market financing conditions could further weaken growth prospects and increase vulnerabilities in a number of countries. They also noted the potential for further volatility in oil prices in the event of a deterioration in the security situation in the Middle East.

Against the backdrop of heightened uncertainty about the strength of the recovery, Directors agreed that macroeconomic policies in most industrial countries will need to remain accommodative for longer than had been expected earlier in the year. Should the outlook weaken further, some further easing in monetary policy will likely be needed in the United States and in the euro area, provided inflationary pressures remain subdued in the United States and come down as expected in Europe. Directors noted that among emerging market economies, policy priorities necessarily vary widely. Where there is room for policy maneuver, they felt that the macroeconomic stance should, in general, remain accommodative, but in countries facing external financing difficulties, the restoration of financial market confidence through appropriate policies should be the priority. Looking ahead, Directors concurred that, in most industrial and emerging countries, fiscal restraint and progress with ongoing structural reforms will remain the essential priorities needed to strengthen and broaden the sources of growth over the medium-term, to reduce global imbalances, and to improve resilience to future economic shocks.

Major Currency Areas

Turning to the prospects for the major currency areas, Directors agreed that recent indicators still generally point to the continued moderate recovery in the *United States*, supported by the further fall in long-term interest rates, the lower dollar, and the macroeconomic stimulus still in the pipeline. They noted that, nevertheless, important uncertainties to the outlook remain. These uncertainties relate to the extent to which equity market developments and corporate accounting scandals will affect consumption growth and investment recovery, the extent of overcapacity in a number of industries, and the outlook for productivity growth. Against this backdrop, Directors recommended that the Federal Reserve should wait to withdraw monetary stimulus until the recovery is firmly established, and that it consider further easing if incoming data remain weak. While fiscal policy has provided welcome support to activity during the economic slowdown, Directors noted that following its recent deterioration, the medium-term fiscal outlook will need to be strengthened. Many Directors recommended that the U.S. authorities adopt a medium-term budgetary framework directed at attaining budget balance over the business cycle, both to increase domestic saving and to better prepare for the fiscal pressures from population aging. Noting that restoration of confidence will be key to underpinning the recovery, Directors welcomed the U.S. authorities' swift actions to strengthen corporate governance and auditing, and considered that their vigorous implementation and enforcement, as well as their possible further strengthening if needed, will be crucial to ensuring that they have the necessary impact.

Directors were encouraged by recent indicators in *Japan*, suggesting that activity is stabilizing. They were concerned, however, that economic signals still remain mixed. With the outlook for domestic demand remaining weak, the modest rebound projected for the rest of 2002 and for 2003 is subject to downside risks, particularly if, in an uncertain external environment, the global recovery turns out to be weaker than expected or if the yen appreciates further. Directors agreed that strong implementation of structural reforms to improve the financial health and profitability of the banking sector, accelerate corporate restructuring, and increase investment opportunities remain key to strengthen Japan's growth prospects durably. To support activity in the short-term, most Directors recommended a more aggressive monetary stimulus, combined with a public commitment to end deflation in the near future. In view of the high level of public debt, Directors agreed that the focus of fiscal policy will need to turn toward gradual consolidation. They suggested that in the context of an acceleration in structural reforms, the authorities should consider maintaining a neutral fiscal stance in the short run to mitigate any initial negative impact on growth of the reforms.

Directors noted that recovery is not yet well established in the *euro area*, with domestic demand still weak—especially in Germany and Italy—and the resilience of export-led growth possibly at risk should the global recovery falter. Several factors should, however, support a steady—albeit moderate—pickup in activity in late 2002 and in 2003, including growth in household and corporate earnings, lower inflation—partly as a result of a stronger euro—and improvements in labor market performance over recent years. Given the hesitant recovery, and with risks to price stability having become more balanced, Directors concurred that monetary policy should remain on hold for the time being, and that the ECB should stand ready to consider interest rate cuts if activity weakens and inflation declines as expected. With budgetary positions in several countries having become more difficult, most Directors saw little room for maneuver on the fiscal front. Directors generally were of the view that in most euro-area countries, a further strengthening of fiscal positions over the medium-term will still be needed to prepare for the effects of population aging and to provide scope for reductions in high tax burdens. In addition, building on the significant progress achieved in recent years, Europe should press ahead with the sustained implementation of structural reforms, especially in its labor and product markets, as these will boost productivity and growth potential. Some Directors encouraged deeper analysis of the impact of the structural reforms in Europe on potential output.

Directors welcomed the staff's analysis of external imbalances in the industrial countries during the 1990s as providing a useful framework for discussing policy responses in a multilateral setting. They noted that the significant expansion in current account imbalances among deficit countries reflects faster growth combined with buoyant expectations about future economic prospects associated with the IT revolution, which has supported real demand and fostered autonomous capital inflows. Directors agreed that existing current account imbalances are unlikely to be viable over the medium-term, and that an adjustment will be needed over the coming years, with its speed likely to reflect in part underlying differences in growth prospects across countries. To enhance prospects for a smooth rotation of demand from countries in deficit to those in surplus, Directors reiterated the importance of fiscal consolidation in deficit countries, which should be combined with accelerated structural reforms in surplus countries designed to make these economies more flexible, and enhance their medium-term growth potential and demand.

Emerging Markets

Directors noted that developments and prospects among *emerging markets* are being shaped by the hesitant recovery in industrialized economies, adverse developments—including heightened risk aversion—in international financial markets, and significant economic and political uncertainties in some major economies with large external financing requirements. In particular, Directors expressed concern about the sharp deterioration of economic conditions in Latin America, although some countries continue to resist the region's difficulties reasonably well. They noted that this deterioration partly reflects the turmoil in Argentina and its spillover effects on some neighboring countries, notably Uruguay. The difficulties being faced by a number of Latin

American economies are, however, also largely the result of interactions between domestic political uncertainties and underlying economic vulnerabilities, particularly high debt levels, large external financing requirements, and—in some countries—fragile banking systems. To reduce these vulnerabilities, Directors urged these countries to make further determined efforts to achieve sustainable improvements in fiscal positions, maintain firm monetary policies, and push ahead with wide-ranging structural reforms—including measures to strengthen banking systems and liberalize external trade.

In contrast to most other regions, activity in *emerging Asia* has picked up markedly, led by strong growth in China and India and improvements among countries most oriented to the information technology sector. To reduce remaining vulnerabilities, Directors agreed that in general policy priorities across the region will need to include creating the conditions for a sustainable strengthening of domestic demand, and improving the region's resilience to shocks, including through further bank and corporate restructuring, strengthening medium-term fiscal sustainability, and ensuring appropriate flexibility in exchange rate regimes. Noting the increasing contribution of intra-Asian trade to regional stability and growth, Directors also highlighted the importance of ensuring that the Asian economies remain sufficiently flexible and dynamic to take advantage of prospective changes in intra-regional trade opportunities—including as a result of China's rapid growth and entry into the World Trade Organization.

Growth among most of the *European Union accession candidates in central and eastern Europe* has been relatively well-sustained, aided by strong domestic demand and export growth. Although the high current account deficits in many of these countries have been readily financed, especially through direct investment, Directors suggested continued vigilance to ensure that these investment inflows are sustained. Fiscal restraint, together with structural reforms, will help underpin market confidence and support economic adjustment. Noting the recent increases in economic and political uncertainties in Turkey, Directors urged the authorities to maintain their commitment to macroeconomic stability and structural reforms, including improvements in bank supervision and public financial management.

Directors noted that growth in the CIS—especially *Russia and other countries relatively advanced with economic reforms*—has remained reasonably strong, mainly on account of robust domestic demand. The key medium-term challenge remaining for the region is to accelerate the reform process, especially among the less advanced reformers whose growth performance continues to be hampered by macroeconomic instability, lack of corporate restructuring, and an unfavorable investment climate. Directors looked forward to improved prospects for the lowest-income CIS countries, with technical and financial assistance provided under the CIS-7 Initiative supporting their reform efforts.

Directors noted that growth in *Africa* has weakened in 2002 as a result of commodity price developments, the severe drought in southern Africa, and the remaining conflicts in some countries. The expected strengthening of external demand and improvement in commodity prices are, however, expected to support a pickup in growth in 2003. Welcoming the substantial progress that many African economies have made since the mid-1990s toward macroeconomic stability, Directors agreed that the pressing need now is to improve the overall environment for investment and growth—particularly by strengthening the economic infrastructure and the main market institutions, as well as the quality of governance. In this context, Directors looked forward to the sustained implementation, with appropriate external support, of the New Partnership for African Development (NEPAD) which embraces these key priorities. They also noted the positive contribution of the HIPC Initiative in reinforcing growth prospects and development efforts in the region.

Directors noted that, following the recent slowdown, growth in the *Middle East* is expected to pick up in the near term, assuming the global recovery gains momentum, oil prices remain firm, and the regional security situation improves. In several countries, sustaining stronger and broader-based growth will also importantly require strengthening the fiscal situation and accelerating structural reforms, especially as regards trade and price liberalization.

Agricultural Policies

Directors welcomed the essay on agricultural policies as an important contribution to the increasing body of Fund analysis demonstrating the benefits of trade liberalization for both industrial and developing countries. They noted that the extremely high level of support provided to farmers in industrial countries affects developing countries in various ways—including by depressing the world prices of commodities of interest to poor farmers, and by increasing world price variability. Directors strongly encouraged industrial countries to use the opportunity provided by the Doha round of multilateral trade negotiations to reduce agricultural support and/or shift to less distorting forms of support—moves that would bring aggregate gains by increasing efficiency and real incomes in both industrial and developing countries. Directors also saw a need for food-importing poor countries to receive appropriately targeted assistance to mitigate the effects of higher food prices resulting from liberalization.

Capital Structure and Corporate Performance

Directors welcomed the essay on capital structure and corporate performance with its focus on differences in corporate structures and financial vulnerabilities across emerging market countries. Directors underscored the importance of close monitoring of the health of the corporate sector and of strengthening financial sector supervision, in particular to take account of the significant increase in corporate leverage that normally occurs as countries move from low to moderate levels of financial development. They generally agreed with the main thrust of the staff's findings that greater openness to foreign investment tends to reduce leverage and reliance on short-term debt, thus helping strengthen corporate performance—but cautioned that care should be taken to avoid currency mismatches in balance sheets.

Trade and Financial Integration

Directors welcomed the analysis of trade and financial integration. They noted the observed complementarity of trade integration and financial integration, both over time and across countries, with policy liberalization being the driving force of the integration process in the current episode of globalization. Despite the overall historical trend toward progressive liberalization, today's trade and capital account restrictions across the world continue to restrain global trade flows. Full liberalization around the globe will surely increase international trade flows significantly. Directors also agreed that trade and financial integration tend to reinforce each other. Increased trade integration is naturally accompanied by rising international financial flows, which in turn fosters financial integration. At the same time, increased financial integration fosters trade integration, as financial frictions partly explain the segmentation of global goods markets. Based on this analysis, Directors were of the view that balanced trade and financial integration is essential, since recent experience reemphasizes that an uneven pattern of integration can pose risks to macroeconomic stability. Directors also discussed, and many endorsed, the finding that—along with macroeconomic stability and domestic financial and institutional development—international financial openness reduces output volatility. A number of Directors, however, stressed that financial openness could be risky, especially if the domestic financial sector is insufficiently robust. They also noted that, while greater openness to FDI and portfolio flows is associated with lower output volatility, higher external debt ratios lead to higher output volatility in both financially open and closed economies.

4. NEPAL—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/270, 8/20/02); and Selected Issues and Statistical Appendix (SM/02/272, 8/21/02)

Staff: Shishido, APD; Hadjimichael, PDR

Length: 50 minutes

Mr. Djojosubroto and Mr. Bhatta submitted the following statement:

On behalf of the Nepalese authorities, we would like to thank the staff for a comprehensive and analytical report on the recent economic developments in Nepal. The observations and suggestions put forward by the staff would be most useful in guiding the authorities' design of policy initiatives to meet the socioeconomic challenges faced by Nepal.

The Nepalese economy, which had achieved encouraging macroeconomic performance during the last few years, faced a setback in fiscal year 2001/02 because of the adverse domestic and external situation. Real GDP growth is estimated to have declined to 0.8 percent in 2001/02 from 4.9 percent in the previous year. The poor economic performance is attributed to the deterioration in the peace and security situation in the country, coupled with the events of September 11 that had significantly affected the tourism and manufacturing sectors. In addition, the delayed arrival of the monsoon season and the fall in prices of agricultural products affected the performance of the agricultural sector. Growth of the non-agricultural sector was only marginal owing to the negative growth of the manufacturing, trading, and tourism sectors.

The growth of monetary aggregates further decelerated in 2001/02 from the preceding year's level. The growth of broad money fell from 15.2 percent in 2000/2001 to 5.5 percent in 2001/02. Similarly, credit to the private sector increased by only 5.9 percent compared with 15.8 percent the year before. However, as in the last two fiscal years, inflation remained subdued with the consumer price index rising by 2.9 percent in 2001/02 compared with 2.4 percent in the previous year.

The external sector which was already weak with decelerating export growth and declining service receipts, continued to deteriorate in 2001/02. Exports declined by 14.6 percent in 2001/02 against a growth of 11.7 percent in 2000/01. This was largely attributed to a significant fall in garment and carpet exports as well as the introduction of non-tariff barriers on Nepal's concessional exports by India. At the same time, the slowdown in economic activities and weak export prospects suppressed the demand for both consumer and capital goods, resulting in a 7.7 percent decline in imports.

The overall balance of payments fell into a deficit of 0.6 percent of GDP in 2001/02 after registering surpluses in previous years owing to a sharp decline in services receipts and lower capital inflows. Despite this, gross official international reserves remained high, covering more than 8 months of imports.

Despite Nepal's high dependence on external resources to finance the government budget, its external debt remains manageable. Total external debt stood at 48.4 percent of GDP in 2001/02, approximately similar to the preceding year. However, owing to limited domestic resources, the external debt servicing has increased to 13 percent of total revenue or 13.4 percent of regular government expenditures in 2001/02.

The fiscal situation continued to be under stress as a result of the high expenditure for security needs and the weaker revenue performance attributed to the economic slowdown. The budget deficit, however, narrowed to 5.4 percent of GDP in 2001/02 compared with 5.9 percent in the preceding year

The Nepalese authorities have set "poverty reduction" as its foremost development objective. The Tenth Plan and the policies outlined in the budget speech for the current fiscal year will address this goal despite the emergence of obstacles in the areas of peace and security. The authorities' poverty alleviation programs for the current fiscal year have focused on achieving a broad-based, sustainable and high economic growth, improved quality of social services, development of infrastructure, population management and empowerment, and the protection and creation of income generating opportunities for people living below the poverty line as well as the disabled. The government is finalizing the Tenth Plan along with the Poverty Reduction Strategy Paper (PRSP).

A number of reform measures have been introduced toward fiscal consolidation. The Medium Term Expenditure Framework (MTEF) has been adopted to further rationalize resources and prioritize programs as reflected in the current year's budget. Despite resource constraints, the authorities have allocated necessary funds to programs for the priority sectors and those that will directly benefit the general population. The cabinet has also approved a new policy on foreign aid that sets out the objective of using foreign assistance mainly in the priority areas.

The authorities have also formulated an Immediate Action Plan (IAP) that will prioritize public resources to provide immediate relief to the population and reduce poverty. The IAP also aims to improve the quality of public services and enhance transparency and accountability. The government has also constituted a committee comprising representatives from the Ministry of Finance, the National Planning Commission, and the Office of the Prime

Minister to monitor its implementation and to review progress on a regular basis.

To support the authorities' poverty reduction objectives, a poverty-based formula for allocation of block grants among the local bodies is being developed. The authorities have encouraged greater participation from the community in the areas of education and health services to improve the quality of service delivery. The authorities have also set aside resources to rehabilitate of ailing industries in order to revive the manufacturing sector. They have also decided to grant 10-year multiple entry visas to non-residents of Nepalese origin to attract foreign investments.

However, at the top of the authorities' agenda is the need to restore peace and security in the country. For this purpose, the security agencies have been provided with the required resources to conduct their operations effectively.

A new Income Tax Act that would widen the income tax net has been introduced while the VAT has been made more effective through rationalization measures. With the widening of the income tax net, revenue administration has also been strengthened. In this regard, laws and by-laws governing revenue administration and its organizational structure have been reviewed and simplified. A code of conduct for revenue officials has been introduced. To enhance the integrity of revenue officials, a staff transfer policy has been worked out while guidelines for the entry into and exit from the tax collection service is being considered.

The civil service is being reformed to make it more result oriented with greater responsibility and accountability for policy formulation and program implementation. In this regard, necessary reform measures, including downsizing the civil service, outsourcing of support services and freezing of vacant positions are being implemented. In addition, the compensation policy, contributory pension system, and voluntary retirement schemes are being revised.

The authorities have introduced a new Anti-Corruption Act with enhanced powers being granted to the anti-corruption agency in order to curb corruption and promote good governance. Soon after the new Act came into effect, the Commission for the Investigation of the Abuse of Authority (CIAA) has begun investigating the sources of income of two dozen revenue officials. This was seen as a positive start toward the authorities' efforts to tackle corruption in the country. A high level Property Investigation Commission was also constituted a few months ago to scrutinize the assets of more than 30,000 existing and retired public officials.

With the assistance from the World Bank, the authorities have proceeded to make progress in financial sector reforms to restructure the ailing public sector banks. The management of one of the two largest public sector commercial banks, the Nepal Bank Limited, has been transferred to an external management team while that of the other bank, the Rastriya Banijya Bank, will be transferred to a new management team within the first four months of the current fiscal year. Necessary amendments in the financial sector regulations have been made and the new Nepal Rastra Bank (the central bank) Act has come into effect from the beginning of 2002. The Act provides the central bank with greater autonomy for its operations, including the formulation and implementation of monetary and exchange rate policies. It also sets out a clear and transparent procedure for the appointment and dismissal of the Governor and Deputy Governors.

A new umbrella act for banks and financial institutions is in the process of being enacted to establish a uniform regulatory system for all deposit taking institutions and finance companies. Nepal Rastra Bank (NRB) will be establishing an Asset Management Company this fiscal year. It also plans to issue new directives to strengthen the Credit Information Bureau. Nepal has become a member of the Asia/Pacific Group (APG) on Money Laundering with effect from March1, 2002. An Anti Money Laundering Act has been drafted and will be submitted to the new parliament. As a member of the APG, Nepal is committed to establish an anti-money laundering regime that is consistent with the 40 Recommendations of the FATF.

The central bank has also initiated a number of other reforms like the withdrawal of NRB officials from the boards of commercial banks, phasing-out the priority sector credit program, and withdrawal of the maximum interest rate spread. The commercial banks' cash reserve requirements was also reduced to provide additional liquidity to the market to stimulate economic growth. All these reforms are expected to generate greater dynamism in the banking and financial sector and improve the investment climate in the country.

Nepal is preparing for accession to the WTO and in this regard, its external sector is being liberalized further. The Foreign Exchange (Regulation) Act has been comprehensively amended to incorporate the liberalization measures introduced so far. Nepal adheres to the obligations of Article VIII and would further liberalize its foreign exchange regime as required. However, as convertibility of the capital account has not been established, it would not be feasible to allow unlimited access to foreign exchange, bearing in mind that there is already full convertibility of Nepalese rupees into Indian rupees. Given the low-income levels of the average Nepali, the existing limit on the foreign exchange facility for personal travel abroad (the so called Passport facility) has not been a hindrance to Nepalese traveling abroad. For those traveling for reasons such as business, education, training, medical treatment etc. are able to obtain the required amount of foreign exchange. Regarding the exchange rate regime, Nepal will continue to maintain a fixed exchange rate with the Indian currency, as the country has benefited from such an arrangement.

The Nepalese authorities have met most of the conditions for the proposed entry into a PRGF-supported program with the Fund. The finalization of the Tenth Plan along with the Poverty Reduction Strategy Paper (PRSP) and the adoption of the Medium Term Expenditure Framework (MTEF) to further rationalize both resources and programs are the latest developments in this regard. Nepal's macroeconomic indicators are also broadly on track. Despite its resource constraints, net domestic borrowing of the government has been maintained at about 2 percent of GDP. Monetary discipline has enforced, with money supply growth contained at the desired level. Inflation is well under control and despite the adverse external environment, foreign exchange reserves are at a comfortable level to absorb any external shocks. However, a number of unexpected obstacles, particularly owing to the deteriorating peace and security situation and the unstable political environment, have delayed some of the structural reform efforts. The Nepalese authorities are making their best efforts to overcome these obstacles and expect to enter into the PRGF arrangement with the Fund as soon as possible.

The Nepalese authorities would like to acknowledge the technical assistance provided by the Fund in the various statistical areas. These had benefited the authorities greatly. Following the recommendations of the technical assistance missions, Nepal has introduced a large number of reforms in the area of money and banking and balance of payments statistics. The multi-sector statistics mission has also been useful and Nepal is already participating in the framework of the General Data Dissemination System (GDDS) for the compilation and dissemination of macroeconomic and socio-demographic data. The Nepalese authorities look forward to receiving continued technical assistance from the Fund in the future.

The major challenges facing Nepal are the issues of insecurity and poverty. Parliamentary elections will be held in November this year. The new government is expected to continue on the path of reforms and will expedite the reform efforts in order to reach an agreement with the Fund for a PRGF-supported program that will address the challenges of poverty reduction. However, the authorities recognize that the challenge of reducing poverty in Nepal cannot be met solely by its own resources. Therefore, the authorities need the financial and technical support of the international community in their efforts to reduce poverty.

Mr. Mirakhor submitted the following statement:

The authorities deserve to be commended for their efforts in maintaining macroeconomic stability at the degree they have and for pushing forward their reform agenda under extremely difficult economic, political, and social conditions. Nepal's economic situation deteriorated significantly in 2001/02 as growth declined by 4.2 percent. While intensification of the civil conflict and the global economic slowdown have played a major role in this outcome, the well-prepared Selected Issues paper indicates that deep-rooted structural impediments impose significant constraint on the ability of the economy to achieve rapid and sustainable growth required to alleviate the widespread poverty. As the staff report recognizes (Box 1) and the Selected Issues paper illustrates, economic policy aimed at attaining higher sustained growth to reduce poverty could contribute to the resolution of the civil conflict.

Evidence from other low-income countries suggests that disciplined policy implementation within the framework of a PRGF/PRSP holds the potential of a rapid sharpening of focus on the root causes of poverty, empowerment of the poor, and emergence of social consensus in support of reforms. It is therefore regrettable that, once again, the Board is not in a position to discuss a PRGF-supported progbram for Nepal. In their helpful statement, Mr. Djojosubroto and Mr. Bhatta indicate that the authorities are finalizing their Tenth Plan and the PRSP which, as the staff report suggests, contain policies that "provide a possible framework for a PRGF." The staff report maintains that "a more settled political and security environment was needed before concluding negotiations on a program." What is missing is specificity regarding the appropriate timing for completion of negotiations on a PRGF-supported program. The "base case" scenario discussed with the authorities assumes improvement of the security situation to the "level prevailing before July 2001, a move toward a negotiated solution, and the emergence of a relatively stable government after the November elections." Do these also constitute the conditions which must hold before discussions on a PRGF-supported program could be completed?

In the meantime, prospects for Nepal are not optimistic with realistic downside risks to the projected 3.5-4 percent growth in 2002/03, with a medium-term growth rate of 5 percent. According to the last year's staff report, Nepal needs growth rates twice as large over the next two decades to reach the current IDA threshold. Having a PRGF/PRSP in place can strengthen policy discipline and focus the authorities', stakeholders', and donors' energies toward acceleration of growth rates and implementation of much-needed structural reforms. The authorities and the staff are therefore urged to do their utmost to complete negotiations of a program that can be supported by the Fund, the World Bank, and donors.

Turning to 2002/03 policies, the emphasis placed on revenue mobilization, spending privatization, and domestic borrowing containment is appropriate. While one cannot second-guess the authorities on the need for security-related contingency expenditure, given the urgency of budget consolidation and improvements in the quality of public spending, greater effort is needed toward realization of budgetary savings that would provide head room for security outlays. The staff report's concern regarding the optimism of the revenue target is warranted, given the very low level of economic growth in 2001/02 and the revenue performance of previous years. While some additional revenue measures were introduced in January, no further measures are envisioned for the remainder of this fiscal year. It is regrettable that VAT exemptions could not be addressed more comprehensively in this year's budget. Be that as it may, meeting the ambitious fiscal target requires intensified efforts at improving tax and customs administration. Moreover, greater emphasis needs to be placed on streamlining public expenditures through more efficient prioritization. Additionally, vigilance and close monitoring are required to ensure that domestic borrowing is contained within the 2 percent of GDP target.

The staff report's recommendations on monetary policy are appropriate and consistent with the stance needed to support the exchange rate peg. Mr. Djojosubroto and Mr. Bhatta indicate that monetary discipline has been enforced, and "money supply growth contained at the desired level." For this, the authorities deserve to be commended. The staff report's call for vigilance regarding the quality of new credit has merits and deserves serious consideration.

Turning to the external sector, the pegged exchange rate regime has served the economy well, and the staff analysis shows that the exchange rate appears broadly appropriate. Nevertheless, the short- to medium-term prospects for exports are worrisome, particularly after the new treaty with India (Box 3). The excellent analysis in the Selected Issues paper indicates that, while the civil conflict has exacerbated the poor export performance, there are structural issues that need to be addressed on an urgent basis to reverse the deterioration in export performance. Full consideration and implementation of the staff's recommendations will go a long way toward this objective. Last year's staff report expressed concern regarding the relatively high proportion of the Indian rupee in Nepal's reserves; an issue which was to have been the subject of bilateral discussions. An update of developments on this issue would be helpful.

Progress with the structural reform agenda since the last Article IV discussions have been comprehensively covered in the staff report, the Selected Issues paper, and in the statement of Mr. Djojosubroto and Mr. Bhatta, and need not be repeated here. The authorities should be commended for progress achieved under very difficult and trying circumstances. However, much remains to be done; particularly important are: further progress in implementation of financial sector reform, trade and legal reforms to improve the environment for deeper and wider private sector involvement in the economy, civil service, public expenditure management reforms, and strengthening governance. In this regard, the staff report and the Selected Issues paper contain recommendations that deserve full consideration and implementation.

Finally, we look forward to the Board discussion of Nepal's PRGF-supported program and the final draft of the PRSP. Meanwhile, efforts should be directed to removing the remaining obstacles to full incorporation of the Poverty Alleviation Fund (PAF) into the budget.

Mr. Chatah and Ms. Farhan submitted the following statement:

At the outset, we would like to thank Mr. Djojosubroto and Mr. Bhatta for their helpful statement, and the staff for their candid report and useful selected issues paper, which give a comprehensive and informative analysis of recent developments in and prospects for the Nepalese economy.

Nepal continues to be among the poorest and least developed countries in the world, despite many years of development efforts. More recently, political and social instability and a deteriorating security environment have significantly worsened economic conditions and complicated the authorities' policy. Against this difficult backdrop, however, there are important silver linings. These include the authorities' clear commitment to the path of economic reform and development under the PRSP, which is currently being finalized, as well as the fact that notwithstanding the exceptional circumstances facing the country, relative macroeconomic stability has been maintained. This provides the authorities with a good starting point for mounting a renewed and sustained effort to revive the economy and reduce widespread and entrenched poverty. While a necessary prerequisite for progress on the economic front is peace and stability throughout the country, these are also dependent in turn on the government's ability and determination to put the economy on the right track. While neither the staff nor we are well placed to delve into the politics of the insurgency in Nepal, there can be no doubt that difficult and deteriorating living conditions cannot but fuel malaise and dissatisfaction and increase social and political instability.

There is considerable scope for accelerating economic development in Nepal. The main requirements for such acceleration in our view are: a return of peace and security; prudent macroeconomic policies and strengthened structural reforms; accelerated and effective implementation of social and other poverty reduction programs; continued, and effective use of, international support, both financial and technical; and a pick-up in the global recovery, particularly among Nepal's neighbors and trading partners.

Having said that, we are under no illusion that a quick turn around is likely: even if the insurgency ends, rebuilding the physical and institutional infrastructure and restoring confidence will require considerable time and effort. A firm and sustained commitment to reforms by the government is therefore essential.

In what follows, we will comment, selectively, on some of the major elements of Nepal's policy agenda.

Maintaining macroeconomic stability in the immediate period ahead is an important prerequisite for building the foundations for sustained growth and poverty reduction. On the fiscal front, containing the fiscal deficit within the targeted levels was an uphill task for the authorities in 2001. Slow growth and weak capacity have flattened revenue levels whereas current expenditure, particularly on security, has continued to increase. Meeting the overall fiscal target, however, has unfortunately been at the expense of reduced development spending. Given the continuing economic slowdown and the deteriorating fiscal position projected for the near term, prudent expenditure and debt management is urgently needed in order to strengthen the fiscal position, ensure macroeconomic stability, and to help secure financing for development projects. We, therefore, welcome the 2002/2003 budget, which appropriately aims at reducing the deficit, while simultaneously enhancing social spending and limiting domestic financing. We are also encouraged by the authorities' commitment to take further measures to ensure fiscal sustainability, should expenditure overruns occur and/or revenues fall below their optimistic target.

Meeting the fiscal targets will require a major improvement in budget planning. The development of a sustainable and realistic expenditure program based on prioritization of projects will be an important step toward that goal. This should be part of a clear medium- term expenditure framework and an overall improvement of the provision of public services. Effective monitoring and evaluation of programs will also be important to ensure their success. This will also require the authorities to strengthen institutional and implementation capacity, in order to enhance the effective and full utilization of both donor funds and public resources. To ensure the long-term sustainability of the fiscal position, the above efforts should also be complemented by further reforms of the public sector, including the civil service and public enterprises. The overall framework should, at the same time, be based on the authorities' poverty reduction strategy.

To ensure the availability of resources further, continued efforts are required to mobilize domestic revenues and expand the revenue base. This should be accomplished first by enhancing collection efforts and improving customs administration. Nepal is in a fortunate position of having a relatively robust tax system. However, broad-based reforms should also aim at increasing the revenue to GDP ratio from its current very low level.

Private sector development, supported by a well-functioning financial sector, will be vital for efficiently allocating resources and achieving higher growth rates. The former will require intensive legal, institutional, and administrative reforms, which can help remove the constraints facing the private sector and improve the business climate. With a return to security, these reforms can also help revive foreign investment.

At the same time, the importance of strengthening the financial sector to support business activities cannot be overemphasized. Here, we concur with the staff's analysis on the need to address the problems of the two largest banks. We welcome the steps already taken to deal with these banks, and look forward to the finalization of the action plan under preparation and its timely implementation. It is also important that auditing, provisioning, and reporting requirements in the banking sector are strengthened. This should be coupled with improving the prudential and supervisory role of the National Bank of Nepal (NRB). Here, we welcome the new NRB and the Banks and Financial Institutions Acts. We are also encouraged by the steps taken to reform the two development banks, which can in turn enhance the allocation of rural finance and boost the development of the agricultural sector.

Nepal needs the full support of the international community, including the Fund, to make meaningful inroads into reducing poverty. We hope that we will soon see a resumption of peace and security, in order for the authorities to focus on the country's enormous reform challenges, and establish the basis for a PRGF-supported program in the near future. We wish the authorities success in addressing the difficult challenges ahead.

Mr. Reddy submitted the following statement:

We wish to thank the staff for a set of useful papers. Read with the insightful statement of Mr. Djojosubroto and Mr. Bhatta, these documents outline the policy options available to the authorities in an environment, which has become more difficult since the last Article IV consultation. A number of factors including the sharp fall in growth, the global economic slowdown, the deteriorating security situation and the present uncertain political environment have made an adequate policy response by the authorities increasingly challenging. The authorities therefore deserve to be commended for their commitment to maintain macro economic stability while laying the foundation for growth directed at addressing the deep-rooted problems of poverty.

It is unfortunate that though a PRGF-supported program for Nepal has been under discussion for a considerable time now, it is still yet to be formalized. Given its present poverty levels, the economy would have to grow well beyond the projected growth rates to meet the MDG, and the PRGF-supported program may be the best vehicle for the country to achieve this. We recognize the requirement for a more settled security and political environment before negotiating such a program, but we hope that this will not result in an undue delay. If the security situation has its roots in the economic disparities as well as the lack of development, the strong implementation of social and economic reforms as well as improvement of basic services under the umbrella of a PRGF-supported program may be the quickest and best way to address it. In this connection, we support the six pronged strategy directed at ensuring strong growth and reducing poverty, which will form the basis of the draft PRSP. The staff may like to indicate the schedule for finalization of the PRSP.

On the fiscal side, we commend the authorities for their initiatives directed at prioritizing spending as well as improving the quality of public services through implementing the Immediate Action Plan. We broadly agree with the staff on the analysis of the fiscal sector. We would like to emphasize two issues. First, while there may be good reasons for setting up the Poverty Alleviation Fund outside the budget, it must be ensured that there are no adverse implications during actual operationalization. There is also a need to build in flexibility as well as a review provision with a view to avoiding complications in budgetary management to the authorities. Second, while the authorities are to be congratulated for maintaining revenue at a steady level during the previous year despite a testing environment, they may face challenges in achieving their higher revenue and grant projections for the current year. In such a case, a deeper prioritization exercise will be necessitated. We hope this will not result in the contingency of a further trimming of development expenditure, which is still below its level in 1997/98.

We are in agreement with the staff that monetary policy adopted by the authorities has served the country well. While we commend the authorities for the various initiatives outlined in the Financial Sector Strategy Statement, we are concerned that the management team contracted to run the RBB withdrew from the contract within six months of taking on this responsibility. We are confident that the authorities will move quickly forward in implementing reforms in this critical sector.

As outlined by Mr. Djojosubroto and Mr. Bhatta, the authorities have rightly set for themselves a critical structural reform agenda. The proposed reform in the civil services will considerably contribute to improving the efficiency of expenditures and enhancing the quality of public services. The reform of public sector enterprises has also been recognized as an equally urgent priority, given the pressure they exert on the budget as well as the drastic deterioration in their profitability over the past three years.

Before concluding, we would like to clarify one issue relating to India, which finds place in the staff documents. We would like to emphasize that our concern must be seen in the light of the fact that the Fund intends to publish these documents. While we note that the staff has identified a number of other factors responsible for the slowdown in Nepalese exports, we are concerned about one reference, that is, "the 2002 Indo Nepal Trade treaty is more restrictive than the 1996 treaty and it introduces various non tariff barriers which will have negative short run consequences for Nepal." Our Indian authorities wish to point out that the 1996 treaty had allowed Nepal to export goods duty free to India, without a value addition norm; while permitting Nepal to impose tariffs on Indian exports. Such a provision led to some third country goods finding unrestricted access to the Indian market, which was totally unintended, thereby creating an anomalous situation and consequently adversely as well as unjustifiably affecting some segments of domestic industry in India. Under the 2002 Treaty, this position has been rectified. Non-reciprocal zero duty access to India is still available to Nepalese exports with a stipulated value addition norm and quantitative limits to ensure the origin of the exports. All exports from Nepal to India above these ceilings are fully permitted under MFN terms. Thus, the amended treaty is part of an ongoing process of rationalization and improvement of the Indo Nepal trade regime. The preferential treatment that India has accorded to Nepal still continues. India is the single largest investor in Nepal and presently there are about 180 Indo Nepal joint ventures. India continues to be committed to foster the economic development of Nepal and the commitment of the original treaty, which was to provide a fillip to Nepal's industrialization, continues. We request the staff to make appropriate changes in the documents to reflect this elaboration, consistent with the recent Board discussions on the deletions policy.

Finally, we wish the authorities all success in their challenging policy endeavors.

Mr. Toyama and Ms. Sekine submitted the following statement:

At the outset, we wish to complement the staff for an analytical report and to thank Mr. Djojosubroto and Mr. Bhatta for their helpful statement.

We are heartbroken over the setback of Nepal's economic performance in 2001/02 and we regret that the Board is not yet in a position to discuss a PRGF-supported program. The Maoist insurgency has led to political instability and economic downturn has been worsened by the slowdown in the global economy and by weak agricultural growth.

We need to bear in mind the indication in Box 1, that pervasive poverty and the perception of unfairness are the root causes of the six-year Maoist conflict. It is encouraging that Mr. Djojosubroto and Mr. Bhatta's statement shows that the authorities recognize this and have set "poverty reduction" as its foremost development objective. In this respect, it is important to outline the goals and to specify the measures for reducing poverty, and we welcome the authorities' finalizing the PRSP.

In order to achieve macroeconomic stability and sustainable growth, the establishment of a stable political environment is most important. Considering the election coming up in November, we expect the authorities' further commitment to restore peace and implement strong structural reforms. This clear commitment will contribute to fruitful PRGF negotiations.

Now we would like to comment on individual issues.

In order to achieve stability and push forward with reforms, we believe that fiscal stabilization is the key issue. We commend the formulation of the Medium Term Expenditure Framework (MTEF) and the Immediate Action Plan (IAP) that will help rationalize resources and prioritize programs in the budget. However, we are concerned that the authorities are expecting more spending in the 2002/03 budgets than the staff suggests. The November election poses the risk that low priority spending might be enforced in order to raise political support. In this respect, we urge the authorities to control expenditures and also to secure peace in order to contain security spending. We agree with the staff that revenue and foreign financing forecasts are too optimistic when economic recovery remains vulnerable. A realistic revenue forecast is essential to avoid overruns in expenditures and domestic borrowing. A new policy on foreign aid indicated in Mr. Djojosubroto and Mr. Bhatta's statement, which aims to use foreign assistance in priority areas, is welcome.

Decline in broad money growth along with stagnant deposit growth is very worrisome when the economy is further declining. Last year, in response to our concern that the sharp decline in credit growth might cause a contraction of the economy, the staff said that the base money growth was just in line with inflation rates and hence there was no issue regarding the movement of base money. The passage of a year has revealed that our concern was real and that the central bank has been forced to take measures to alleviate the liquidity shortage in the inter-bank market. While we approve the authorities' actions, including lowering the cash reserve requirement and cutting refinancing rates to be appropriate, we wonder if such actions should not have been taken sooner. At any rate, prudent monetary policy and banking sector reform is essential to sustain growth. In this respect, we welcome the adoption of the NBR Act and restructuring of the two largest commercial banks, RBB and NBL. We agree with the staff that recapitalization of these banks should be considered after their viable restructuring plans have been put in place.

While Nepal is largely dependent on trade with India, the new bilateral trade treaty might have a negative impact on Nepal. Therefore, the movement to liberalize and increase trade with various countries through WTO accession is important. However, it will expose Nepali goods to serious competition, and we must stress the need to strengthen the domestic industry and diversify export products to increase international competitiveness.

We welcome the efforts to streamline the public sector by downsizing the civil service, outsourcing support services, and freezing vacant positions, etc. Professional training of human resources is also necessary. The implementation of civil service reforms will not be an easy task but one that is essential to carry out. We also commend the movement of corruption control, which will improve the moral and governance of civil servants. We regret that privatization of state-owned enterprises has not made progress over the past few years. In order to streamline expenditures and to develop the private sector, restructuring of SOEs will be important and we expect future progress in this area.

Finally, we would like to encourage the authorities again to provide stability and to secure peace in order to ensure sustainable growth. With these remarks, we wish the authorities the best in their future endeavors.

Mr. Guinigundo and Mr. Jang submitted the following statement:

It is critical for the authorities to focus on key economic policies aimed at addressing the urgent problem of high incidence of poverty in Nepal. In this regard, it is encouraging that the authorities are about to finalize the draft of the full PRSP. Given that foreign assistance is uncertain, it is clear that fiscal consolidation should be pursued through more effective expenditure management and stronger revenue collection. The financial system in Nepal is still worrisome because of large non-performing assets. Despite continued government transfers, public enterprises continue to perform poorly with a decline in net profits owing to poor management. Early privatization is needed to improve efficiency.

We recognize the difficulty of Nepal's overall macroeconomic situation and note that it has remained a challenge in past years, compounded by the fact that 40 percent of the total population lives in poverty. This situation has been exacerbated by an intensification of both the insurgency problem and adverse external developments. In a situation where pervasive poverty and a perception of inequity are considered to be among the root causes of the six-year old conflict (as indicate in Box 1), it is critical for the authorities to zero in on economic policies that would contribute to a resolution of the conflict.

In this regard, it is encouraging that the authorities are about to finalize the draft of the full PRSP which would include the main elements of a poverty alleviation strategy and induce a prospective PRGF-supported program. We believe that PRSP should include considerable improvements in all major areas of economic management covering governance, macroeconomic and structural policies, institutional capacities and transparency, which are all essential to make progress toward growth and poverty reduction.

There are some key issues that merit the full attention of the authorities.

First, given that foreign assistance is uncertain, it is clear that fiscal consolidation should be pursued to attain fiscal efficiency and to reduce fiscal deficits. This calls for more effective expenditure management and stronger revenue collection efforts. On the expenditure side, it is encouraging that the authorities presented the 2002–2003 budget by MTEF. We believe it will enhance the efficient allocation of resources. While we are pleased to learn that the 2002–2003 budget canceled one-third of the 550 existing projects according to a pre-determined spending priority, we share the staff's view that increased security outlays should not be used for lower priority activities. On the revenue side, as the staff pointed out, more vigorous efforts should be made to improve revenue collection through stronger tax and customs administration. If both public revenues and foreign aid are expected to fall short of target, the authorities are encouraged to cut non-priority spending further rather than resorting to additional domestic borrowing. With regard to fiscal decentralization, we share the staff view that it should be implemented cautiously given that the administrative capacity of local authorities is limited and information on local public finance is absent, although it will improve public service delivery in meeting the needs of Nepalese.

Second, Nepal's financial system is still worrisome considering that two of the largest commercial banks have a negative net worth amounting to 7–9 percent of GDP owing to large non-performing assets. If the government was to use public funds to mitigate the banks' financial condition without viable restructuring plans, it will induce moral hazard problems and worsen the current fiscal situation even further. We are reassured by the authorities' intention to deal with these problems by all means, including liquidation and privatization, as recommended by the external managers. A great deal of effort is also necessary to restructure the two government-owned development banks. To this end, the NRB should be authorized to supervise the two development banks directly by enacting the Banks and Financial Institutions (BFI) Act as early as possible. In line with strengthening supervision, we believe it is important to further liberalize the financial sector by reducing administrative control in order to enhance the efficiency of financial intermediation.

Third, we agree with the staff on the importance of public sector reforms, including public enterprises reform. However, there has been little progress in reforming public enterprises. We also note that public enterprises continue to show declining net profits despite sustained government transfers and investment. This has stemmed from a lack of commercial incentives, poor management, and overstaffing. Furthermore, the cost of poor public enterprises will continue to be high: there will be a deterioration of public finance as government transfers continue. We believe that early privatization is necessary to correct this. We share the staff view that contingent fiscal liabilities in public enterprises would have to be cleared prior to privatization by issuing bonds. It is encouraging that the authorities are endeavoring to improve civil service delivery by reducing the size of lower-level employees and contracting out some services to the private sector. To firm up the reform of the civil service, an amendment to the Civil Service Act will need to be made immediately.

Mr. Lundsager and Mr. Epstein submitted the following statement:

Nepal's economy faces significant risks associated largely with homegrown factors, such as lower government spending on growth-enhancing (private sector) development and a tenuous investment climate, partly a result of the internal security situation. We believe that while the current security environment poses critical challenges to the national government, the authorities are also faced with the need to enact and implement prudent fiscal policies now in order to stem a worsening fiscal situation in the future. If not, we fear that further fiscal deterioration can lead to significant macroeconomic imbalances, which would only further endanger the progress in Nepal's economic development. Notwithstanding the absence of a Parliament which hinders the advancement of key structural reform legislation, the national authorities can make progress on a number of different fronts, namely to focus budget priorities on growth-enhancing investments and supporting immediate poverty-reduction interventions.

Public expenditure management is critical, as emphasis is shifting away from development priorities and toward military expenditures and as the domestic debt burden increases. We note Nepal's over reliance on donor assistance, which we believe is not a prudent approach to determining budget priorities. Rather than relying on donor aid to cover growing contingent liabilities stemming from the financial sector and public enterprises, the government ought to take clear-cut steps to reduce the fiscal burden of the loss-making institutions and to accelerate civil service reform to reduce long-run operating costs. In that vein, we concur with the staff's concerns that current revenue targets are overly dependent on foreign aid to meet budgetary shortfalls. We also agree with the staff's recommendation to accelerate privatizations in order to help reduce the fiscal drain.

On fiscal decentralization, as was discussed in the well-written and helpful Selected Issues paper; we believe that sequencing reforms is critical to support a successful decentralization approach. The lack of institutional capacity in Nepal and the unsecured political environment in the rural areas raise questions on the timing of transferring more authority to the local governments, notwithstanding the appealing nature of fiscal decentralization, including in Nepal. A prudent approach might be to focus first on building up local capacity, through emphasizing transparency, improving accounting and auditing standards.

Strong export growth is a key component for robust economic growth. While Nepal's slowdown in export growth over the last two years is largely the result of exogenous factors (for example, weaker global demand), the composition of Nepal's exports, which are mainly garments, puts it at risk, particularly as the Multi-Fiber Arrangement phases out. This clearly is a telling argument for the need to promote export diversification toward a wider range of products as well as export markets.

On exchange rate policy, while acknowledging that Nepal's exchange rate peg with the Indian rupee is broadly appropriate, we wonder whether Nepal could benefit in the medium-long term if it were to move to a more freely floating exchange rate regime. Perhaps the staff could elaborate on this, particularly as Nepal seeks to expand trade liberalization and build a wider export market.

Accelerating financial sector reforms is an important step in the authorities' strategy to support strong and sustainable medium-long term economic growth and poverty alleviation. While we share the staff assessment of the progress made to date with Nepal's financial sector initiatives, we note that key challenges remain. In particular, we concur that the highest priority continues to be the need to address the problems of the two largest and insolvent commercial banks (RBB and NBL), while the restructuring of the two large development banks (ADBN and NIDC) is also a priority. We also agree with the call for vigilance concerning the quality of bank lending and the need to strengthen bank supervision.

Regarding anti money laundering (AML), we welcome Nepal's entry into the Asia/Pacific Group on Money Laundering. As noted in Mr. Djojosubroto and Mr. Bhatta's helpful statement, Nepal's new membership reflects its commitment to establishing an AML regime consistent with the 40 recommendations of FATF. On combating the financing of terrorism (CFT), Nepal has been supportive of international efforts to block the funding of terrorists. We urge the authorities to continue to take steps to ratify and fully implement the UN Security Council Resolutions and Conventions related to terrorism, as called for in the IMFC Communiqué.

On the prospects for a PRGF-supported program, we believe the authorities must demonstrate their own progress on the economic and structural reform agenda, notwithstanding the current security challenges. That is, the current security problems should not hinder or divert the government's focus on public expenditure reform, civil service reform, private sector development, and poverty reduction interventions. In that regard, we note that despite such challenges, there was progress made with the finalization of the full PRSP and the adoption of the Medium-Term Expenditure Framework, per the staff report.

We welcome the safeguards assessment conducted in early July and urge the authorities to fully comply with the staff's recommendations. We look forward to the final safeguard assessment report.

Mr. Marques made the following statement:

The Nepalese economy has performed well in the last few years thanks to the continued efforts of the authorities to maintain macroeconomic stability and advance their reform agenda under very difficult economic, social, and political conditions.

Unfortunately, however, the economic outlook has dimmed. According to the Central Bureau of Statistics, the year 2002 has seen a slowdown in all productive sectors, which has reduced GDP growth to its lowest level in 18 years. An immediate turnaround is unlikely: if the insurgency were to end tomorrow, it would take a long time to rebuild lost confidence.

Because it depends largely on the monsoon rains, which seem to be on time, agricultural production may improve soon. However, the rest of the economy will need more time to recuperate, and will deteriorate further if the conflict continues. War for another years could halt development activity entirely. In addition, the authorities would have to finance security measures, and actions aimed at improve the security situation, forcing them to borrow excessively unless donors step in to help.

Nevertheless, donors also want to see improvements in governance and service delivery before they provide more funding. It must be understood that in and of itself a military victory will not ensure a return to normal if nothing is done to remove the underlying causes of the insurgency—widespread poverty, corruption and weak governance, discrimination, and disrespect for human rights. The possibility of change will depend on the outcome of the general election and on the availability of adequate financing to end the insurgency and support development activities.

Nepal's external sector has also suffered damage. Trade has slowed and chances are slim for an imminent export revival. Nepal's principal export to overseas markets—ready-to-wear garments—faces cheaper competitors who have now penetrated the U.S. market. Exports of woolen carpets, mostly to Europe, have reached a plateau. Moreover, despite Mr. Reddy's useful explanations of the new India-Nepal Trade Treaty, Nepal's exports to India may face new structural hurdles which past experience indicates may not be quickly resolved.

Meanwhile the halt in growth has caused government revenues to stop growing, but recurrent expenditures have continued to increase, partly because of security outlays. Reducing development spending to get money for security needs ironically worsens the poverty cycle that caused the insurgency in the first place. The authorities must mobilize more revenues, prioritize their expenditures, and contain domestic borrowing. Combined with prudent monetary policies, these actions offer the only hope of sustaining growth.

On structural reforms, I commend the authorities for their impressive progress under near-impossible circumstances, particularly in the financial sector. Now the emphasis should shift to reforming public sector enterprises and the civil service, improving public expenditure management, and strengthening governance. I welcome the progress made so far with anti-corruption measures, but urge the authorities to adopt a more direct and better-focused approach.

Finally, given the relationship between poverty and the insurgency, completing a full PRSP would be the next step toward a PRGF-supported program. Given the authorities' continued focus on social spending, and recent establishment of a Poverty Alleviation Fund, I look forward to Nepal's early completion of PRGF negotiations.

With these remarks, I wish the authorities every success.

Mr. Jin made the following statement:

I thank the staff for its comprehensive and well-written report and also Mr. Djojosubroto and Mr. Bhatta for their informative statement. I broadly agree with the staff appraisal and would like to make some comments, mainly as emphasis.

The major challenges facing Nepal are the issues of poverty and insecurity. As pointed out by the staff, both of these two issues have been partially caused for the same reasons, namely inequitable access to economic opportunities and poor institutional governance. The slowdown of economic growth in 2001/02 has further aggravated the economic difficulties of this country. However, the overall macroeconomic indicators show that a severe imbalance has been avoided, judging by the low inflation rate, the current account surplus, the relatively comfortable level of foreign exchange reserves, and a not too high fiscal deficit. This will provide some room for the authorities to achieve macroeconomic balance in the short term and to focus their efforts on structural issues that could improve economic performance in the long run.

On fiscal policy, efforts should be made to contain the fiscal deficit mainly through further revenue mobilization. We share the staff's view that invoicing requirements should be enforced, audits for large taxpayers need to be done at a higher frequency, and import valuations should be checked more tightly. We are encouraged to learn from Mr. Djojosubroto's statement that a New Income Tax Act has been introduced and a staff transfer policy has been worked out while guidelines for the entry into and exit from the tax collection services is being considered. We hope these measures will be fully implemented in order to enhance the integrity of revenue officials. It is also encouraging to learn that the Commission for the Investigation of the Abuse of Authority (CIAA) has begun investigating the source of income of two-dozen revenue officials. It is hoped that this kind of investigation could be carried out on a regular and systematic basis and in a transparent manner.

While making major efforts to mobilize revenues, it is also imperative to streamline expenditure by prioritizing different items, with emphasis being given to poverty reduction and social stability. We believe the above measures will not only improve the budget condition and therefore enhance microeconomic stability, but also address the people's concerns on inequality.

Monetary policy has been broadly on track and we share the staff's view that the current exchange rate arrangement has served Nepal well. The potential threat to the monetary stability may come from the problem in the banking system that is still widely using priority lending and has damaged asset quality. We are encouraged to learn from Mr. Djojosubroto and Mr. Bhatta's statement that the authorities intend to establish a uniform regulatory system for all deposits taking institutions and finance companies and that they plan to issue new directives to strengthen the Credit Information Bureau. However, the withdrawal of management from one of the two largest commercial banks (NBL) is a cause of concern. Both the authorities and the staff should evaluate the reasons carefully and ensure the accountability of the management team that will be hired in future. It is interesting to learn from the report that a significant part of the contingent fiscal liabilities associated with banks and public enterprises will be covered by donor aid. We would like to know the source of this donor support and to what extent this can be done. The staff's comments are welcome.

On external sector reforms, it is important for the authorities to carry out their preparation for accession to the WTO and their efforts to further liberalize the external sector is welcome. As about half of Nepal's exports are directed to India, the negative impact of the renewed bilateral trade treaty with quantitative restrictions on four of Nepal's export items is a source of concern.

We would like to learn the background of this arrangement and the staff's comments are welcome.

We support the authorities' expressed interest in a PRGF-supported program and would like to see an arrangement made at the earliest possible time.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Litman made the following statement:

Despite the concerns about the security situation in Nepal, I believe that economic as well as political stability in the country is best achieved by the continued involvement of the international financial institutions as well as of donor countries. I therefore support entering into a PRGF arrangement with Nepal before the next Article IV consultation. The staff should maintain a close dialogue with the authorities to finalize the full PRSP, which according to the Report, appropriately focuses on improving agricultural productivity, promoting more efficient resource allocation, especially in the financial sector and public service delivery, and strengthening governance. While I do not contest the commitment of the current government to the reform, I recommend waiting and seeing whether a new government, formed after the November elections, will have strong commitment and capacity to implement the reform. The implementation of the program can contribute to the DIP, improve the administrative capacity of local government, add to its financial resources, increase its accountability, and help to establish monitoring of local government activities.

Because most of the poor live in rural area—many living on subsistence agriculture—the government's development efforts were directed to sustain high growth in agriculture, but they have been ineffective in reducing poverty. An alternative approach could be considered. Some of these areas may have tourist potential which with improvement in infrastructure could be utilized. Backpackers are not big spenders, but they will need only basic facilities which require relatively low investment. Still, even small spending could constitute substantial additional income for the poorest. Other, more affluent, eco-tourists may follow.

The two largest commercial banks are insolvent. They account for over 40 percent of the public's deposits. Nobody knows the extent of their negative net worth, because the most recent estimate is four years old. One of the banks is currently managed by external manager, while the other is not, as an international firm decided to pull out. The slow growth of the economy probably deteriorated the banks' loan portfolio even further and increased the negative net worth beyond 7-9 percent of GDP, as estimated in 1998. A prompt estimate of the banks' net worth should be the highest priority.

Finally, I would like to commend the staff on a well-written and clearly argued report. The selected issues were wisely chosen. I really appreciated Box 1 on Poverty and the Maoist Insurgency. The list of pros and cons which compares the pegging of the Nepalese rupee to the Indian currency (which the staff continues to support) with pegging to a basket of currencies, which reflects more correctly the composition of the Nepalese trade, would have been useful.

Mr. Taylor made the following statement:

The staff report presents a sound analysis of the economic challenges facing Nepal. We agree that the near- and medium-term outlook is critically dependent on how the security and political situations evolve. The civil conflict is the key risk to the macroeconomic outlook. Restricted movement of people has prevented agricultural migrants from returning to their land during the current paddy planting season, leading to a reduction in the area under cultivation. This, together with the poor monsoon, will likely cause agricultural production to be affected. With agriculture forming the mainstay of the Nepalese economy, and with the decline in tourism receipts owing to the internal security situation as well as the slowing demand for exports, we are concerned that it may prove very difficult for Nepal to avoid the low growth scenario described in Annex V. While inflation may remain subdued overall, a poor agricultural yield could lead to significant increases in food prices. We therefore believe that there is an urgent need for substantive measures to tackle both the causes and the consequences of the conflict.

On the fiscal front, we agree with the staff that there are significant downside risks to the revenue and foreign financing forecasts in the budget. Limited absorptive capacity because of institutional constraints and the impact of the conflict may reduce aid disbursements. It will be critical that revenue and/or aid shortfalls are addressed through the suspension of low priority projects, rather than through an increase in domestic borrowing. We certainly welcome the improvements that have been made in public expenditure management, with the reduction in the number of projects, prioritization of the development budget, and formulation of a medium-term expenditure framework. However, robust measures to tackle corruption and improve accountability will be essential if donors are to move away from project-based assistance. In this regard, full implementation of the Immediate Action Plan will be essential. We agree with the staff's recommendations on the need for steps to be taken to reduce the fiscal burden of loss-making enterprises by vigorously pursuing privatization. Nonetheless, in the current climate, interest from potential investors may be limited. In the short term, the government might well focus on reducing the liabilities of state-owned enterprises to prepare the way for eventual privatization or liquidation.

We welcome the start that has been made on rationalizing the civil service, including maintaining the hiring freeze, improving incentives for performance, and completing the survey on vacant posts. We hope further progress will be made quickly, including the elimination of these vacant posts.

On monetary policy, we agree that the peg with the Indian rupee continues to provide a suitable nominal anchor.

On financial sector reform, we have long regarded progress with the restructuring of the two large commercial banks, RBB and NBL, as a litmus test for progress on the wider structural reform agenda, and consequently we particularly welcome the progress that is now being made with the NBL. The withdrawal of the external management team from the RBB contract was unfortunate, however we are pleased to hear that a new team will be appointed shortly.

We welcome the steps the authorities have taken on anti-corruption legislation, and look forward to further progress in the implementation of these new laws. Another indicator of the authorities' intent to tackle corruption will be to take firm legal action against loan defaulters.

Finally, we look forward to the publication of the PRSP. The civil conflict is hindering the government's ability to deliver public services in rural areas, and we believe it will be important, perhaps by building on the IAP, to improve the delivery of social services in these areas by considering alternative mechanisms for service delivery outside district headquarters, as the absence of basic health and education services have been identified as key conflict drivers.

Mr. Al-Nassar made the following statement:

Nepal faces a number of critical challenges. The deterioration in the security situation combined with the adverse external developments has aggravated the economy's difficulties significantly. This adds to the challenge of adjustments and reforms toward higher growth and reduction of poverty. Here, I welcome Mr. Djojosubroto and Mr. Bhatta reassurance regarding the expected continuing of the authorities' policy commitment.

As I broadly agree with the staff appraisal, I will only make a few brief remarks for emphasis.

Fiscal consolidation is a priority in view of the risks arising from the security needs and the economic slowdown. In this regard, the authorities are to be commended for the effort to contain the deficit in the 2001/2002 budget. The further deficit reduction as envisaged in the 2002/2003 budget is also encouraging. However, I share the staff's concern on the downside risks to the revenue and foreign finance forecasts. Therefore, it is essential to strengthen tax collection and improve the customs administration. The authorities are also encouraged to develop a contingency plan for further spending adjustments if needed and to avoid relying on borrowing.

Rehabilitation of the financial sector is critical. The large nonperforming assets in the two largest banks are a concern. Here, assigning external management teams to prepare plans for restructuring these banks is a welcome step. In this regard, the authorities are encouraged to implement the teams' recommendations in a timely manner. The analysis in the Selected Issues paper shows that reform of the microfinance institutions is important to enhance growth and reduce poverty in the rural sector. It is also important to broaden the reach of the Nepal Rastra Bank's (NRB) supervisory and regulatory powers to all commercial and development banks.

The public sector reforms need to be strengthened. While the steps that have been taken to reform public expenditure management are encouraging, restructuring and privatization of the public enterprises has been limited. Here, I join the staff in urging the authorities to move ahead with privatization of the enterprises included in the active list and to resolve the liabilities for the ones already closed. I also agree that consideration should be given to adopting international accepted accounting standards in the large public firms.

Finally, with forty percent of the population living in poverty, a substantial reduction of poverty within a reasonable period of time is a major policy challenge. Given the country's capacity limitations, the authorities will clearly require technical and financial support from the international community. In this context, I welcome the authorities' effort to finalize the PRSP which should facilitate an early adoption of a program under the PRGF.

With these remarks, I wish the authorities success.

Mr. Vogel made the following statement:

I thank the staff for a well-written report, and Mr. Djojosubroto and Mr. Bhatta for their helpful statement. The efforts that the authorities have made to achieve macroeconomic stability are commendable and some progress has been achieved. Moreover, the authorities should be commended for their efforts to open the economy through the reduction of tariff rates and establish a friendly legal framework for investment.

Nonetheless, we remain concerned about the vicious circle of low growth, poverty, social instability, and weak structural policies. The main challenge that the authorities are facing is to break the circle for which enhanced structural reform and improved governance will be critical. Nepal should be able to accomplish a higher growth rate over the medium-term as a necessary condition to alleviate poverty.

On the fiscal side, given the resource constraints, spending should be prioritized. In this regard, we welcome the Immediate Action Plan that will prioritize public resources on social services that provide relief to the population and reduce poverty and The Medium Term Expenditure Framework, to be introduced with assistance from the World Bank, and that will ensure consistency over time of the fiscal programs.

Meanwhile, as Mrs. Lundsager and Mr. Epstein underline the government ought to take steps to reduce the fiscal burden of the loss-making institutions and accelerate civil service reform. As the background paper underscores, the civil service sector has shown several problems in terms of its size and structure, including composition, wage scale, and pension liabilities. All of which represent obstacles to promote sustained growth and social development. Mr. Djojosubroto and Mr. Bhatta's announcement on civil service reform nevertheless encourage us, with greater responsibility and accountability for policy formulation and program implementation.

Box 4 of the main staff report is very clear on the performance of the public enterprises. In this regard, despite the continued government transfers and investment, the table of summary indicators shows a significant deterioration in the net profit of the 39 enterprises. Still restructuring and privatization have been limited.

Turning to other structural reforms, we welcome the efforts that the authorities have been making in improving governance. In this regard, measures that aim to improve fiscal transparency are critical. Additionally, it is necessary to make further progress in terms of transparency and improve official statistics.

With these comments, we wish the authorities every success in their future endeavors.

The staff representative from the Asia and Pacific Department (Mr. Shishido), in response to questions and comments from Executive Directors, made the following statement:

There have been a number of questions raised in the statements and two more questions have been raised in today's discussion. Let me start with the questions that were addressed in various statements.

Mr. Mirakhor asked whether there has been any new development with regard to the discussions between Nepal and India on the use of Nepal's Indian currency reserves. This issue was discussed during last year's Article IV consultation. The answer is yes, there have been some discussions according to the Nepalese authorities. They have requested the Indian authorities to let them invest in Indian treasury bills with maturities longer than 90 days. Negotiations are still ongoing, but we understand that no positive response has yet been received from India. Thus, the issues that were discussed last year still remain.

Ms. Lundsager and Mr. Epstein wondered if the adoption of a more flexible exchange rate would benefit Nepal in the medium term. While we agree that a more flexible exchange rate regime could benefit Nepal as it moves toward more diversified exports and export markets in the medium to long term, we can list a number of factors that could justify keeping the current regime for the foreseeable future. This is of course provided that the authorities conduct macroeconomic policies prudently and the Indian currency is not misaligned.

The most important reason is Nepal's location. Its largest neighbor, India, has a diversified industrial base, and given similar consumer tastes in both countries, India-Nepal trade is expected to remain large, especially as a share of Nepal's total exports and imports. Second, shocks that these countries receive will be fairly similar. Third, to have more flexible exchange rate management in an efficient manner requires institutional capacity that Nepal has not yet developed. For these reasons, Nepal will continue to benefit from the current exchange rate regime of pegging its currency to India's.

The third set of questions is on the PRGF-supported program, and were raised by Mr. Mirakhor, and many other Directors. A specific question was raised on whether assumptions used in the best-case scenario of the staff report represented conditions for reaching agreement on a PRGF arrangement. The answer is no. That scenario is simply a technical projection and is not linked to PRGF negotiations. More generally, we hope to make progress in the PRGF discussions as soon as feasible. In fact, the last Article IV mission's brief had a mandate to intensify PRGF discussions. Unfortunately, during our mission, parliament was dissolved and the current government became a caretaker government until the November elections. In this circumstance of heightened political uncertainty, it was considered prudent and appropriate for us to wait until after the elections. However, as soon as a new and stable government is put in place, we intend to visit Kathmandu to resume talks on a PRGF-supported program. In this regard, it is obvious that ,as we intensify negotiations, we need to assess the security and political situations and their impact on the authorities' capacity to implement PRSP-related reforms. Given the recent progress that the authorities made in reform implementation (for example, in the financial sector) under very difficult conditions, we remain hopeful that we can make progress when a new government is put in place after the elections.

The last question raised in preliminary statements was on the timeframe for preparing a PRSP, which came from Mr. Reddy. A draft of the PRSP has been finalized. and is expected to be submitted by the National Planning Commission's working group to the Cabinet in a few days. The plan is that the Cabinet will issue it at end-September or early October. There is, however, a slight complication because some political oppositions are now insisting that this "caretaker" Cabinet should not be making a multiyear commitments such as those in a PRSP, and should delay issuing the document until after the November elections. Nonetheless, the authorities have informed us that the current plan is to have the PRSP finalized and issued by early October.

Mr. Jin asked if donors are likely to finance the contingent liabilities associated with reforms of commercial banks and public enterprises, noting from the staff report that the authorities wish to have them financed largely through donor assistance. On the commercial banking side, the World Bank and other major donors are involved in providing technical assistance in commercial bank reforms including financing of external managers. The authorities are also requesting that these donors possibly finance the restructuring cost of troubled commercial banks. While nothing concrete has happened, I understand discussions are ongoing.

On the public enterprise side, owing to accounting problems, the size of the contingent liabilities is not known accurately. However, technical assistance has been provided to prepare for public enterprise privatization . But, there has been no firm discussion on donor financing of public enterprise contingent liabilities. As a first step, the size of these liabilities need to be gauged and each enterprise's future viability assessed before more discussions take place. However, the authorities are claiming that the absence of donor commitments for financing public enterprises contingent liabilities makes it difficult to establish a credible implementation plan for public enterprise reforms.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael), in response to questions and comments from Executive Directors, made the following statement:

The staff is grateful to Mr. Reddy for providing a number of clarifications with regard to the India-Nepal trade agreement that explain the underlying rationale for the new terms of this agreement. The staff is aware of these reasons. The details provided both in the staff report and in the accompanying background paper provide some elaboration of the significance of these measures. Notwithstanding the intentions, certainly from the point of view of the Indian authorities, the short-term implications for activity in Nepal remain negative. In the background paper, some more analysis is provided about the complications this could pose for trade diversification. For example, it is indicated that in addition to the quotas imposed as a way of minimizing any elicit exports (originating outside Nepal) into India, there is the imposition of specific quotas on some agricultural products, such as ghee, from Nepal into India. The additional complication, as explained in the paper, is that the rights to purchase this commodity would be given to only one purchaser in India, which is a monopsony. That is an issue that will complicate trade with Nepal. In addition, we understand that there will be some checking points for the agricultural goods that go from Nepal to India that could cause administrative delays in processing the trade. The staff did not want to get into the details of all of this, because we may not know all the facts. We remain of the view that the brief statement made in the report, namely that the short-term impact will possibly be negative, remains valid.

As to whether the deletions policy would allow a modification of what is indicated in the staff report, I regret that the existing rules, as reconfirmed in the recent Board discussion on transparency, do not allow changes that are not market sensitive. Such changes usually relate to exchange rate issues, interest rates, bank reforms, and so on. Even if they were to be market sensitive, the Board's consensus, as I understand it, was that the possibility of third-party suggestions for deletions will not be allowed. Therefore, only the Executive Director representing the country for which the report is issued could request deletions.

Mr. Bhaskar clarified that he was not requesting that a deletion be made to the staff report, but rather that the elaboration provided by the Indian authorities on some information contained in the staff report be included somewhere in the papers.

The Acting Chair (Mr. Aninat) suggested that Mr. Bhaskar continue discussing the matter bilaterally with the staff.

Mr. Bhatta made the following concluding statement:

The staff representative from the Asia and Pacific Department has answered most of the questions, and I fully agree with the staff. I would like to thank the staff representative and his team for their excellent work and also for promptly responding to the various questions raised today.

On behalf of my Nepalese authorities, I would like to thank colleagues for their valuable comments and suggestions. I will convey your comments and suggestions to my authorities, and hope that your constructive suggestions will be helpful in formulating policies and implementing them.

As one of the poorest countries in the world, Nepal needs the full support of the international community to accelerate its economic development and reduce poverty. For the past couple of years my Nepalese authorities have been trying their best to negotiate a PRGF arrangement with the Fund, with the expectation that a PRGF-supported program can be one of the best ways toward reducing the problems of poverty and economic disparity. We hope that with the cooperation and understanding of the staff and management, our authorities will be able to negotiate one very soon. In this context, we also appreciate the support and suggestions, as expressed by many speakers, for an early PRGF arrangement with the Fund.

Finally, I would also like to thank management and the staff for the continued technical support to Nepal in a number of areas.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. Noting that the deteriorating security situation and adverse external shocks had contributed to the recent weakness in growth, they welcomed the authorities' efforts to maintain macroeconomic stability and to push ahead with structural reforms under these difficult circumstances. However, Directors noted that the economy remained vulnerable to downside risks in the near term, including the impact of the insurgency on production, exports, and tourism, as well as a weaker than expected global recovery. In view of the widespread poverty, they called on the authorities to demonstrate a firm and sustained commitment to reforms in order to reinvigorate growth.

Directors agreed that sound fiscal management was key to maintaining macroeconomic stability, and stressed the need to contain domestic borrowing, prioritize spending, and mobilize revenue in implementing the 2002/03 budget. They welcomed the recent steps taken to prioritize development spending within a multiyear framework and to strengthen expenditure control. In light of the budget's optimistic revenue and foreign financing assumptions, the achievement of the targeted overall deficit will probably require additional efforts during the course of the fiscal year, focused on raising revenue and cutting low priority spending, so that domestic borrowing can be contained.

Over the medium term, Directors endorsed the authorities' intention to strengthen revenue mobilization further, with an emphasis on improving tax and customs administration through increasing the frequency of audits, raising staffing resources, and tightening enforcement. This would permit higher spending for poverty reduction and growth—and success in these areas could contribute to the resolution of the civil conflict.

Directors considered that the exchange rate peg to the Indian rupee remains broadly appropriate given Nepal's close economic links with India, and they endorsed the focus on maintaining monetary conditions consistent with the peg. They encouraged the authorities to maintain an open trade and investment regime, while noting the adverse effects of trade barriers on Nepal's exports. A few Directors drew attention to the need to remove the exchange restrictions that limit payments for personal travel.

Directors encouraged the authorities to remain vigilant about the quality of new bank credit at a time of weakening bank loan portfolios, and to build on the progress made in financial sector reform—especially by addressing the problems of the two largest commercial banks. They looked forward to the preparation and implementation of plans to divest these banks' state assets, and to recapitalize the banks after they had been appropriately restructured under new management. Directors also encouraged the authorities to proceed with the restructuring of the two large development banks. They welcomed the progress in strengthening the central bank, including the passage of the new central bank law that gives the bank greater autonomy, and the authorities' commitment to establish an anti-money laundering regime consistent with the recommendations of the Financial Action Task Force.

Directors urged the authorities to strengthen public sector reforms. They welcomed the initial steps to reduce the overemployment of lower-level civil servants, but said that further efforts will be needed to eliminate vacant positions and improve incentives for professional staff. Directors recommended that the authorities revive their efforts to privatize public enterprises listed for early sale and assess the financial position of other enterprises with a view to making decisions on future privatization.

Directors welcomed the recent efforts to improve governance and enforce anti-corruption policy, focused on those responsible for the misuse of public funds. They stressed the need to increase fiscal transparency by fully monitoring central and local government finances, as well as extrabudgetary activities, such as those of the Poverty Alleviation Fund. The importance of the adoption of international accounting and auditing standards for large private and public firms was also emphasized, as an element of progress toward legal, institutional, and administrative reforms that will foster an environment that is supportive of private sector activity.

Directors welcomed the government's commitment to a comprehensive reform program, as described in the government's Poverty Reduction Strategy Paper, to maintain macroeconomic stability and promote more efficient resource allocation in the financial sector and better public service delivery, especially in the rural areas, together with strengthened governance. Such a program would lay the foundation for sustained growth once a more stable political and security environment is established. They looked forward to Nepal making progress toward designing and implementing a program that could be supported by the Poverty Reduction and Growth Facility.

Directors encouraged the authorities to continue to improve the macroeconomic database to eliminate deficiencies in official statistics that currently impair effective monitoring and policy formulation. They stressed the importance of implementing past technical assistance recommendations on statistics.

Directors welcomed the authorities' support for international efforts to combat the financing of terrorism.

It is expected that the next Article IV consultation with Nepal 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/02/91 (9/3/02) and EBM/02/92 (9/4/02).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 02/63 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBAM/02/110 (8/30/02) is approved.

APPROVAL: November 22, 2002

SHAILENDRA J. ANJARIA
Secretary