November 14, 1997
Approval: 11/21/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/64

10:00 a.m., June 25, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
M.-A. Autheman	A. Fayolle
	N.R.F. Blancher, Temporary
	J. Chelsky, Temporary
	W.-D. Donecker
E.R. Grilli	
D.Z. Guti	J.P. de Morais
	D. Gotz-Kozierkiewicz
	R.F. Cippa, Temporary
	W.K. Gruber, Temporary
	H. Kaufmann, Temporary
	H.F. O'Brien
	A.L. Coronel, Temporary
W. Kiekens	J.A. Akhmetova, Temporary
K. Lissakers	B.S. Newman
	D.G. Loevinger, Temporary
A. Mirakhor	M. Daïri
	S. Rouai, Temporary
	A. Vernikov
	J. Shields
A.S. Shaalan	
	H.B. Disanayaka
	V. Trivedi, Temporary
E. Srejber	B. Andersen
G.F. Taylor	O. Kwon
	J.K. Honeyfield, Temporary
J.J. Toribio	J. Guzmán-Calafell
	Y.G. Yakusha
	L.B.J. van Geest, Temporary
	P.I. Botoucharov, Temporary
K. Yao	A. Barro Chambrier
Y. Yoshimura	S. Fukushima, Temporary
	S. Joyosumarto
	Han M.
	Qi J., Temporary
A.G. Zoccali	N. Eyzaguirre
	J.A. Costa, Temporary

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
D. de Vos, Assistant

Also Present

IBRD: W. Shaw, International Economics Department; R. Morales, Cofinancing and Project Finance Department; E.M. Favaro, Latin America and the Caribbean Regional Office; M. Giugale, Europe and Central Asia Regional Office. African Department: A. Tahari. Asia and Pacific Department: H. Shishido. European II Department: J. Berengaut, D.J. Donovan, P. Garibaldi, T.D. Lane, A. Lopez-Claros, J.R. Marquez-Ruarte, T.A. Wolf. External Relations Department: S.J. Anjaria, Director; I.S. MacDonald. Fiscal Affairs Department: J. Escolano. Legal Department: R.C. Baban, H. Elizalde, H.V. Morais. Middle Eastern Department: M. Zavadjil. Policy Development and Review Department: J.T. Boorman, Director; T. Leddy, Deputy Director; B. Christensen, M.E. Dow, U. Erickson von Allmen, M. Fisher, K.H. Kang, W.C. Keller, K. Lee, B. McDonald, E.C. Offerdal, J.P. Pujol, S.M. Schadler. Research Department: M. Mussa, Economic Counsellor and Director. Secretary's Department: P. Gotur, K.S. Friedman, A. Mountford. Treasurer's Department: D. Gupta, A.W. Lake, P.R. Menon. Western Hemisphere Department: C.M. Loser, Director; M. Bonangelino, Deputy Director; J.-P. Amselle, P.D. Brenner, L. Cubeddo, L.H. Duran-Downing, T. Gudac, M. Guerguil, E.S. Kreis, G.L. Terrier, M. Zermeno. Office of the Managing Director: J.A.P. Clément, O.J. Evans. Advisors to Executive Directors: M. Askari-Rankouhi, S.S. Farid, A. Giustiniani, C.M. Gonzalez, A. Guennewich, G.M. Iradian, J.M. Jones, R. Kannan, A. Levy, M.-H. Mahdavian, M.F. Melhem, H. Ogushi, Y. Patel, O. Sein, M. Sobel, Zhang F. Assistants to Executive Directors: W.F. Abdelati, H.I. Abdul Rahman, J.G. Borpujari, M.A. Brooke, K. Brownlee, H.W. Cocker, D.A.A. Daco, C.K. Duenwald, J.C. Estrella, Huang X., O. Issaev, H. Javaheri, M. Kell, K. Kpetigo, A. Lucenti, F. Mercusa, D. Merino, L. Palei, A.R. Palmason, H. Paris, J.L. Pascual, G.P. Ramdas, V. Rigász, J. Roaf, O. Schmalzriedt, T. Schneider, Y. Tahara, M. Vismantas, A.G. Yakub, E.L. Zamalloa, Zubir bin Abdullah.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he wished to report on his recent travel to the Republic of Estonia, Israel, and Ukraine. He had visited Estonia in order to participate in a conference held at the Bank of Estonia on June 18, 1997 to celebrate the fifth anniversary of the reintroduction of the Estonian kroon and, therefore, of the currency board. The conference had been addressed by Estonia's president, the prime minister, the governor of the central bank, Mr. Raymond of the European Monetary Institute, and himself. There had also been a panel discussion on the euro and eastern Europe with the governor of the Finnish central bank, Bundesbank Board member Mr. Jochimsen, and other central and private bankers, some of whom were from eastern Europe. Other than the discussions on European Economic and Monetary Union—in which differing views had been expressed by the governor of the Finnish central bank and by Mr. Jochimsen on how and at what speed to proceed—the discussions had been noncontroversial. The conference had been a pleasant one, in light of the substantial goodwill toward the Fund and the justified satisfaction of Estonians for their achievements over the previous five years.

Estonia was performing well in terms of inflation; its rate had fallen recently to single digits—although it was not expected to remain at that level—the First Deputy Managing Director noted. The current account deficit had become large, however, and the staff had begun preliminary discussions with the authorities on the measures necessary to stabilize the situation, including a possible follow-up arrangement to the current precautionary Stand-By Arrangement. He had been accompanied on his visit by a staff representative from the European II Department, the resident representative for Estonia, and Mr. Andersen, who had also attended the conference.

He had visited Ukraine to discuss the implementation of prior conditions for the Extended Arrangement negotiated in November 1996, on which progress had been slow, the First Deputy Managing Director continued. It looked as if the parliament, the Rada, was unlikely to accept some key measures included in the recently tabled budget. He had met with the president twice, with the economic team, including the governor of the central bank, and with the deputy prime minister, who headed the overall reform effort. The president had expressed a determination to implement the Extended Arrangement and to meet its conditions, and did not as yet wish to discuss any other alternatives. He would express his full support for the reform program in public, which he had perhaps not done to the extent expected when the Extended Arrangement had been negotiated in November 1996. To the president, he had emphasized that the Fund recognized fully that much progress had been made on the macroeconomic side, with the fiscal deficit targets being met, inflation staying low, and the exchange rate being reasonably stable. There had also been a fair amount of structural reforms, albeit far less than had been expected under the Extended Arrangement. He had stressed to the president that progress would have to be made relatively soon, if the Extended Arrangement were to be the vehicle of Fund support. Indeed, the period between the arrival of a mission on July 1 and the recess of the Rada on July 18 would be critical in determining whether or not the Extended Arrangement could proceed.

He wished to thank Mr. Yakusha for his major efforts to arrange the meetings on short notice, and for his invaluable participation in those meetings, the First Deputy Managing Director added.

In Israel, he had participated in a conference on anti-inflationary policy, the First Deputy Managing Director said. By chance, his visit had coincided with a major political shake-up in which the finance minister had resigned after the government had accepted a proposal by the Bank of Israel to widen the exchange rate band and to lift capital controls; the bank had hoped those actions would remove one-way speculative bets on the currency, which had been contributing to inward capital inflows. After the widening of the band, the Bank of Israel had cut its interest rate significantly, and the shekel had depreciated by 3.3 percent but was still reasonably far above the lower end of its previous band. The package, at least in the short run, seemed to have achieved a depreciation of the shekel, in line with the intentions of the Bank of Israel and contrary to the expectations of the finance minister. Progress had been made in reducing inflation, which was expected to be below double digit rates for 1997, and was currently at a rate of about 8 percent, representing a reduction in the annual inflation rate of 3–4 percentage points over the previous eight months. As there was no finance minister, he had met with the new Director General of the Treasury, to familiarize him with the Fund's activities and to obtain his views on the economic situation.

The conference on inflation had been excellent, with many participants from countries that had successfully reduced inflation, including Spain and Australia, the First Deputy Managing Director remarked. He had delivered the same paper—prepared jointly with his advisor—on ending moderate inflations as in Estonia.

He had also met the resident representative in the West Bank and Gaza, Mr. Fayyad—previously a member of the Board—the First Deputy Managing Director indicated. The representative had said that the Palestinian economy was improving in some aspects, mainly because the number of migrant workers in Israel was higher than it had been in 1996 and was currently well in excess of 60,000. The budget of the Palestinian Authority was also in reasonable shape. While the political uncertainty made it difficult to expect major growth in the Palestinian economy, the economic situation was better than he had expected. From the viewpoint of the international financial institutions, the representative had stated that the key challenge was the implementation of projects; each year, donors promised billions of dollars in aid, yet only about $150 million in projects was subsequently implemented. The representative and the World Bank believed that a rebalanced effort of lower donor pledges and increased project implementation would help the economy.

2. ENHANCED STRUCTURAL ADJUSTMENT FACILITY—USE OF RESOURCES FOR COMMERCIAL DEBT- AND DEBT-SERVICE-REDUCTION OPERATIONS—FURTHER CONSIDERATIONS

The Executive Directors considered a staff paper on the use of the resources of the Enhanced Structural Adjustment Facility for commercial debt- and debt-service-reduction operations (EBS/97/94, 6/4/97; see also EBS/97/42, 3/11/97).

The staff representative from the Legal Department made the following statement:

> This statement explains the legal difficulties of implementing the proposal to limit the use of ESAF resources for financing debt- and debt-service-reduction (DDSR) operations only to countries eligible for assistance under the Debt Initiative for Heavily Indebted Poor Countries (HIPCs) within the framework of the existing ESAF Trust. It also indicates how such a proposal, if approved, could be implemented either through a suitable

amendment of the 1987 ESAF Trust Instrument or through the establishment of a separate new facility.

The basic legal difficulty with the proposal is that it would be contrary to the principle of uniformity of treatment among ESAF-eligible members. This principle may be compared, but on a limited scale, with the general principle of uniformity of treatment for rights and obligations under the Articles of Agreement. This means: First, on the part of the Fund, that it must act in a manner that does not discriminate among its members; that is, its treatment of members must be uniform and comparable, allowing no preference in favor of any one member or group of members. Secondly, on the part of the member, it means that if it satisfies the objective criteria for receiving assistance set out in the Articles of Agreement or under any special policies adopted thereunder, it would be entitled to uniform access to the use of resources under the same conditions as any other member. The principle of uniformity of treatment is also implicitly recognized in the relevant provisions of the ESAF Trust Instrument. Thus, when the Fund transferred resources from the Special Disbursement Account (SDA) to the ESAF Trust pursuant to Article V, Section 12 (f)(ii) upon the establishment of the ESAF Trust in 1987, it established "special terms" for the use of ESAF resources for "developing countries in difficult circumstances" and for this purpose was authorized to take into account the level of per capita income. As applied in this case, the principle of uniformity of treatment means that all members falling within this classification or sub-group of ESAF-eligible members must be treated uniformly by the same special terms established.

The sole criterion (i.e., "special terms") established in the ESAF Trust Instrument for access to ESAF resources is that a member has a "protracted balance of payments problem." The determination of whether a member has a "protracted balance of payments problem" is to be made by the Fund, in its capacity as Trustee of the ESAF Trust. In making this determination, the Fund would look, among other things, at the member's external debt liabilities and how these liabilities affect its balance of payments position. In other words, the member's external debt situation is one of several elements to be considered in making the balance of payments assessment. It is not a separate criterion. Therefore, any proposal to limit ESAF financing for DDSR operations to a subgroup of ESAF-eligible members—for example, HIPCs or African countries or Sub-Saharan African countries—to the exclusion of all other ESAF-eligible numbers would be inconsistent with the principle of uniformity of treatment that should apply to all ESAF-eligible members with respect to availability and use of resources of the facility. Specifically, the proposal would have the effect of disqualifying all other ESAF-eligible members from receiving similar support, even though these other members may have a "protracted balance of payments problem," on the basis of a consideration that is extraneous to the Instrument—that is, that those members are not HIPCs.

In effect, the proposal would materially change the eligibility criterion under the ESAF Trust. The ESAF Trust was specifically established to provide loans on concessional terms to all low income developing members. There is nothing in the ESAF Trust Instrument which would permit the Fund to discriminate between one group of low income developing members and another. In fact, the Instrument established eligibility for assistance by reference to members on the list annexed to Decision No. 8240-(85/56) SAF, and states that all these members shall be eligible for assistance from the Trust.

Moreover, there is at present no legal impediment whatsoever under the terms of the ESAF Trust Instrument for any ESAF-eligible member to use the proceeds of its ESAF loans to finance DDSR operations. The reason why the Fund has not financed DDSR operations in the past is that several Executive Board members had previously expressed reservations about the use of concessional resources to finance such operations in respect of commercial bank creditors.

The proposal, if implemented, would effectively result in the creation of two categories of ESAF-eligible members with different entitlements and different terms by placing a new restriction on the access to, and the use of, ESAF resources by non-HIPCs. Specifically, the Fund would not be able to consider financing of DDSR operations as a component of the size of a member's balance of payments need in determining access to ESAF resources for the non-HIPCs. Thus, resources initially transferred from the SDA or contributed by donors and lenders to the ESAF Trust for all ESAF-eligible countries would no longer be available on the same terms and conditions to all ESAF-eligible countries.

The only possible way of implementing the proposal would be to create a new sub-facility for HIPCs. The creation of this new sub-facility for a limited group of ESAF-eligible members would have to be treated as a new use of SDA resources and a transfer of resources outside the ESAF. As the decisions to transfer SDA resources to the ESAF Trust required an 85 percent majority of the total voting power (pursuant to Article V, Section 12(f)), the adoption of the proposal would similarly require a decision of the Fund by an 85 percent majority of the total voting power. Furthermore, in order to become effective, such a decision would also require the consent of all ESAF contributors.

Mr. Bernes and Mr. Chelsky submitted the following statement:

At our last discussion of this issue, I expressed concern with the prudence of using ESAF resources for commercial DDSR operations, particularly at a time when adequate financing for the Fund's participation in the HIPC Initiative and a self-sustained ESAF were in serious question. At that time, several Directors shared my concerns and a somewhat larger number were troubled enough by the implications of this change to delay Board approval and request further information from the staff on a variety of operational issues.

The staff has done a competent job in responding to the questions raised and in so doing, I am persuaded of the wisdom of allowing for the use of ESAF resources for commercial DDSR operations, but only in a more limited sense than is being proposed. Indeed, with the elaboration provided in the staff paper, my Canadian authorities are now even more convinced that allowing for the broad use of ESAF resources for commercial DDSR operations as proposed would be inadvisable for a number of reasons.

First and foremost, I would argue that the risk of an insufficiently-financed, self-sustained ESAF is more than just a "possibility," as the staff argue, but a significant "probability." Assume for a moment that the HIPC Initiative were fully financed (a proposition in serious question, particularly given our recent extension of the framework and the competing demands for bilateral resources for the Initiative from the World Bank and the African Development Bank). It turns out that virtually all the assumptions underlying our earlier estimate of a self-sustained ESAF of SDR 800 million have proven overly optimistic—a gold sale will take place later than early 1997; and the price of gold has declined from $385 to around $340. While these developments have partially been offset by a decrease in the value of the SDR from 1.55 $/SDR to 1.39 $/SDR over the period, on balance, our estimate of a self-sustained ESAF of SDR 800 million, ceteris paribus, may be on the high side.

But the Fund's participation in the HIPC Initiative is not yet fully financed and bilateral contributions, even through SCA-2, are far from being adequate to cover the anticipated costs. Should this not be fully rectified, an early transfer from the Reserve Account will have to be made and the level of a self-sustained ESAF will be consequently diminished.

To avoid this happening, there are only two sources for augmenting a self-sustained ESAF—one internal, the other external. We can undertake gold sales of more than 5 million ounces or we can further augment bilateral contributions. On the former, while my authorities would be prepared to consider such action, I presume there would be others for which sales beyond 5 million ounces would be unacceptable and this Board would be once again unproductively divided on this issue. That leaves increased bilateral contributions which, given fiscal pressures on aid budgets and competing demands on a variety of other fronts, is by no means a sure bet. It is against this backdrop that we are considering using the same ESAF resources to support commercial DDSR operations.

At the same time, I accept the staff's argument that for some countries, for which commercial DDSR operations are clearly beneficial, the use of nonconcessional GRA resources may not be appropriate. Therefore, I believe that the use of ESAF resources, given their scarcity (and other considerations, which I explain below), should be on a very exceptional basis and I would argue that only HIPCs with the greatest need and a record of strong performance are the appropriate candidates.

There are many reasons for undertaking to use ESAF resources for commercial DDSR operations only in the context of HIPC operations. First, this allows us to target our debt relief efforts to countries with the heaviest debt burdens. Second, it will allow us to contain the costs and minimize the impact on a self-sustained ESAF, thereby protecting the availability of ESAF resources for all low-income countries. Third, it ensures that such exceptional use of scarce concessional resources is only undertaken for countries with track records of good performance and in the context of ESAF programs which are considered to be among the "stronger ESAFs." Indeed, I was troubled by the paper under discussion today in that it made little or no link to the nature or strength of the conditionality associated with access to ESAF for commercial DDSR operations. It also seemed as if the timing of access to ESAF for this purpose and the degree of front-loading in the associated arrangement was more a function of when agreement had been reached with commercial creditors than it was a reflection of past performance under ESAF programs and the strength of upcoming commitments.

Largely because of the need to ensure that only good performers receive access to ESAF for commercial DDSR operations and then only in the context of a strong and comprehensive adjustment effort, I have no problem recommending that such access be restricted to the post-decision point period of eligibility. Indeed, if we were to do this, such access could serve as one (but not the only) mechanism for the Fund to deliver interim assistance to the country—a point which would partially address the oft-cited criticism of my colleague, Ms. Lissakers.

At this point, we should recall that the absence of access to ESAF resources for non-HIPC qualifying countries does, in no way, jeopardize the ability of the country in question to undertake a commercial DDSR operation, nor does it prevent the Fund participating—through the GRA—in the financing of the operation. I do not, therefore, see any risk that, as the staff suggest in paragraph 11, "the emergence of the HIPC Initiative [would] rule out further Fund support for DDSR operations in the few relevant cases." In fact, under most (if not all) foreseeable circumstances, financing for such an operation will be comprised of the country's own resources, highly-concessional donor resources, and a grant from the IDA Debt Reduction Facility (IDRF). General IDA resources—which are significantly more concessional than ESAF resources—might also be available (although it should be recalled that this has not yet occurred). If the Fund were to participate with GRA resources (which, after all, are likely on considerably better terms than the country could obtain itself on private markets), these would represent only a portion of the financing package, the overall concessionality of which is the most important factor from the standpoint of affordability.

Also, if we extend eligibility for ESAF resources for DDSR operations to all ESAF borrowers, should we not also consider whether or not low-income countries which have already made use of GRA resources for their DDSR operations be permitted to refinance their outstanding GRA obligations on ESAF terms? Consistency of treatment and fairness would seem to suggest this, particularly given that the countries that have already undertaken such operations have tended to be among the better performers and surely they should not be penalized for having moved first.

I should also comment on the staff's suggestion that other donors—particularly the World Bank—might be reluctant to provide concessional resources for commercial DDSR operations without similarly concessional resources from the Fund. Indeed, it has been suggested that the World Bank would insist on such complementary action. I presume that this refers to IDA resources and not IDRF resources since the latter have been provided along with GRA resources already in the past. On the need for ESAF to complement IDA resources, I would note that any assertions on the part of the Bank in this regard are the preferences of management and not the decisions of the Bank's Executive Board which has not, to my knowledge, come to such a conclusion nor been asked to consider the question.

In justifying the Fund's continued use of GRA resources for non-HIPC-qualifying countries, I would also note that ESAF resources are significantly scarcer than are IDA resources and that both IDA and ESAF resources are essentially donor resources. If donors, and the respective Boards, do not object to Bank management's perceived asymmetry of treatment, these objections should be put aside.

Clearly, if only countries qualifying for treatment under the HIPC Initiative are eligible to use ESAF for commercial DDSR operations, then use of ESAF in this context is truly additional. We then have addressed the concern the staff voice in paragraph 17 and the grant element of a DDSR ESAF credit can be considered as a portion of the Fund's contribution at the completion point. Indeed, as the staff note in paragraph 18, failure to count ESAF resources used for a commercial DDSR operation would result in lower contributions from all other multilateral creditors. We would, in effect, be (unintentionally) subsidizing the contributions of all other multilateral creditors at the completion point. While this may be desirable with respect to the African Development Bank, this is not an efficient way of providing such subsidization since the resources cannot be targeted to any single multilateral creditor.

The staff has responded to an earlier suggestion in this regard by pointing out that the World Bank does not intend to count allocations from the IDRF or the grant element of IDA DDSR credits toward its contribution to the Debt Initiative. This is appropriate with respect to IDRF contributions since this mechanism existed prior to the Debt Initiative and, just as Paris Club debt reduction up to and including Naples Terms does not count as part of the contribution of Paris Club creditors, neither should IDRF grants. With respect to the grant element of IDA DDSR credits, it is important to remember that no such credits have ever been extended, and once again, the World Bank Board has not, to my knowledge, been asked to consider the parameters of a policy to allow for the use of IDA resources for commercial DDSR operations. When they do, they can decide to adopt a similar approach to the Fund or not. In any event, I do not believe that we should set our resource allocation policy based on what the World Bank decides, and I see no inconsistency between a broader availability of IDA resources for commercial DDSR operations than for ESAF resources if that is what the respective boards choose. Indeed, it is interesting that the staff expect a DDSR operations for Vietnam with IDA resources but no ESAF contribution from the Fund (Table 1).

I have some broader concerns with using ESAF for commercial DDSR operations in anything but an exceptional way. As the staff note, there is the risk that the availability of concessional Fund support for commercial DDSR operations could displace other more concessional financing. For example, if we make ESAF available as suggested by the staff, will we not also create an incentive for the World Bank to underfund the IDRF, which receives most of its resources from allocations of IBRD net income? This is of particular concern given that IBRD net income is expected to decline precipitously in future, and there are a number of other costly demands being placed on it, including HIPC financing and increased waivers for middle-income countries. If this were to occur, it could have negative implications for countries for which IDRF resources are expected to be adequate for their commercial DDSR operations (e.g., Guinea, Guyana, Togo, and Yemen).

Next, there is, as the staff note, "considerable uncertainty" on the final cost of their proposed change to the use of ESAF. This is compounded by the fact that, at our previous meeting, they would not preclude using ESAF resources in operations for which the secondary-market value of commercial debt is not available on a "deep" discount. Staff estimate a cost to the Fund of between SDR 60 and SDR 162 million (and possibly higher, since the staff cannot rule out an increase in the secondary market value of outstanding debt if ESAF resources become broadly available for commercial DDSR operations). This potentially amounts to more than a full year's income from the sale of 5 million ounces of the Fund gold. The amount is not trivial.

Finally, I am concerned with the public optics of using scarce concessional ESAF resources for what will undoubtedly be perceived as a commercial bank "bail-out," particularly if the staff's proposed change results in an increase in the secondary-market value of the outstanding debt. This is problematic when the adequacy of resources for multilateral debt relief is in question—both with and outside this institution—and there are public concerns about restricting access to the HIPC Debt Initiative because of resource constraints. Should this perception gain much public profile, it will certainly make it more difficult for my authorities to rally domestic support for allocations to finance the Fund's participation in the HIPC Initiative and for a self-sustained ESAF.

It is for these reasons that I can only support allowing ESAF resources to be used for commercial DDSR operations in the context of HIPC operations. I ask management and my fellow Directors to give careful consideration to the above arguments and consider a more selective approach. I would, at the same time, reiterate my ongoing support for the use of GRA resources in commercial DDSR operations for countries not qualifying for the HIPC Initiative.

Mr. Shaalan made the following statement:

We would like to thank the staff for this paper which clarifies the queries raised in the April meeting. We are hopeful that the information provided would allow us to come to a conclusion of this matter today. As we stated previously, we can agree to the proposed use of ESAF resources for DDSR operations since it represents a logical evolution of the Fund's policy, begun in 1989, by which this institution has supported such operations through the provision of GRA resources. The rationale behind extending the policy to the use of ESAF resources is clear, in view of the protracted balance of payments and debt difficulties of many low income countries. The timing of this change with the launching of the HIPC Initiative also seems most appropriate. Additionally, we would note that the remaining cases of commercial bank debt to be dealt with represents a small residual, when compared to $120 billion of member's commercial bank debt which has already been restructured with Fund support since 1989. Evenhandedness among members would require making such Fund support available to all qualifying members. It is certainly not the time to reappraise the Fund's role in the debt strategy at this point, rather it makes sense to find a way to deal with the remaining few cases by providing terms that are appropriate to the circumstances of the countries concerned.

While we can sympathize with the view, expressed by many, including most recently Mr. Bernes in his gray, that the use of ESAF resources for DDSR operations would constitute additional demands on limited and still unsecured resources, the staff's calculations of the Fund's potential contribution to what we view as a worthwhile operation, would not appear to alter significantly the resource requirements of the current or interim ESAF. Conversely, we note that the provision of ESAF resources compared to GRA resources is likely to reduce, though only modestly, the amounts the Fund would need to provide under the HIPC Initiative. Having said that, we must express our deep concern, nonetheless, with the prolonged uncertainty that continues to surround the financing of the interim and self-sustained ESAF and would urge an early conclusion of this important issue.

On the possible options to deal with the situation in which an anticipated DDSR operation does not take place, in view of the shortcomings identified by the staff in the first two options, we would favor the third option, that is the incorporation into the annual ESAF arrangement of a special disbursement for the sole purpose of financing part of the DDSR operation only if the operation materializes.

On the question of whether the Fund should or should not seek to claim credit under the HIPC Initiative for this use of resources, if we understand the staff report correctly, to do so the Fund would need to limit such assistance to those low income countries that qualify for the HIPC Initiative. In our view, the principle of evenhandedness would preclude such a limitation. Fund assistance in DDSR operations by low income countries should be available regardless of the member's qualification for the HIPC Initiative. Accordingly, we agree with the recommendation that it not be counted as part of the Fund's contribution to the HIPC Initiative.

Finally, in reference to Mr. Bernes' statement, I am troubled by his proposal to link the use of ESAF resources for DDSRs with the strength of the ESAF programs. His reference to "stronger ESAFs" implies the existence of two tiers of ESAF programs, some worthy of DDSR support and others not.

The assumption has always been that the Fund only enters into strong ESAFs and hence the distinction should not arise.

To conclude, as we noted in the previous discussion on this issue, we would stress the importance of appropriate burden sharing in such operations between the Fund, IDA and other donors as well as financing from the member's own resources.

The Director of the Policy Development and Review Department noted that Messrs. Bernes and Chelsky had suggested that, if ESAF resources were to be used for DDSR operations, the eligibility criteria should be more limited than those proposed by the staff. The staff shared Messrs. Bernes and Chelsky's concern over delayed funding of the extension of ESAF and the HIPC Initiative, which was one of the motivations for their suggestion. The soon-to-be-circulated paper on revised cost estimates for Fund financing of HIPC Initiative operations (EBS/97/127) would indicate that the Fund's costs would increase from those estimated in the staff's June 1996 statement (BUFF/96/70). The delay in the transfer of SCA-2 resources to the ESAF-HIPC Trust from the timing assumed previously would decrease the estimated earnings accruing to that account from those resources. Similarly, the delay in possible gold sales would also reduce projected interest earnings on profits from that account. At present, it was difficult to estimate the total impact of those factors on the self-sustained ESAF, given the estimate would depend, in turn, on whether the targets of the ESAF-HIPC Trust were revised and on whether the targets were met fully. Moreover, the estimates were subject to the assumptions on the pace of use of ESAF resources from the present to end of the interim ESAF, in about 2004. The extent of any shortfall would also depend on whether or not less than 5 million ounces of gold could be sold while still meeting the current ESAF-HIPC Trust target of SDR 2½ billion—on an as-needed basis for ESAF subsidies and for HIPC costs. That, of course, would depend on the size of bilateral contributions.

Given the foregoing factors, the staff's proposals on the use of ESAF resources for DDSR operations had not been made lightly, the Director emphasized. The proposals had been possible, in part, because the additional costs would be relatively modest—albeit not trivial, as Messrs. Bernes and Chelsky had pointed out. The latter had proposed reducing those costs even further, by limiting the use of ESAF resources for DDSR operations to countries qualifying for relief under the HIPC Initiative, and by limiting access to the post-decision point period of eligibility.

As Directors considered the alternatives proposed by the staff and by Messrs. Bernes and Chelsky, it would be useful to keep the following points in mind, the Director indicated. First, as compared to the staff's proposal, the proposal by Messrs. Bernes and Chelsky would likely exclude one or two countries, and thereby reduce somewhat the costs estimated by staff—by less than 1 percent of the targeted contributions to the ESAF-HIPC Trust, or about SDR 25–30 million out of the target of SDR 2½ billion.

Second, in the early stages of an ESAF arrangement, the proposal could delay normalization of relations with creditors for a country not yet at the decision point but likely to qualify for assistance under the HIPC Initiative, the Director considered. If adjustment was successful in such a country, such a delay in dealing with commercial bank debt could possibly increase the up-front cost of reaching agreement with commercial banks.

Third, Messrs. Bernes and Chelsky had perhaps hinted in their proposal at a two-tier standard of conditionality under the ESAF, namely, that for HIPC and non-HIPC cases, which the staff and most of the Board would not wish to see develop, the Director noted. That being said, their comment fitted well with the point that conditionality would have to be appropriately strong for HIPCs to warrant additional support under the HIPC Initiative. Furthermore, he would note that there had not been two standards of conditionality under Stand-By or Extended Arrangements for those countries that had, and those that had not, used financing from the General Resources Account to finance DDSR operations under those facilities.

Fourth, and perhaps most important, the proposal by Messrs. Bernes and Chelsky had raised a legal issue, as the staff representative from the Legal Department had indicated, the Director remarked. The Legal Department believed that the proposal would effectively result in the creation of a new facility for HIPC-eligible countries within the ESAF. Thus resources initially transferred from the Special Disbursement Account—contributed by donors and lenders to the ESAF Trust for all ESAF-eligible countries—would no longer be available on the same terms and conditions to all ESAF-eligible countries. The creation of a new facility for a limited group of ESAF countries would have to be treated as a transfer of resources to outside the ESAF. The adoption of such a proposal would require a decision by the Fund by 85 percent majority of the total voting power, and would also require the consent of all ESAF contributors. For those reasons, the staff continued to support its proposal.

There was a further complicating issue, the Director added. The staff of the World Bank had reviewed the current and previous staff papers before they had been circulated to the Board. In the case of Vietnam, despite the Bank's earlier assurance of Bank support under the IDA Debt Reduction Facility (IDRF)—to be accompanied by bilateral support and the use of Vietnam's own resources—to finance the up-front cost of DDSR operations by Vietnam, the staff had been informed that it could no longer advise the Board that the Bank would proceed with its IDRF support without accompanying Fund support. If the Board were to approve the staff's current proposal, the staff believed that it would be inappropriate to risk a substitution of ESAF resources for more-concessional Bank resources in the case of Vietnam. Although the amount would be relatively small, the staff regarded such a substitution of Fund for Bank resources as neither in the Fund's interests nor Vietnam's. He had indicated to the Bank staff that he would raise the issue in the current Board discussion. He thus sought the Board's guidance vis-à-vis the staff's original understanding that DDSR operations by Vietnam would proceed as indicated originally, and that the staff should not therefore submit any requests for ESAF support for Vietnam's DDSR operations to the Board.

Mr. Mirakhor said that he agreed with the Director that the Fund could sell less gold than expected if it received sufficient bilateral contributions to the ESAF-HIPC Trust, but he wondered whether there was any news indicating that the latter was the case.

The Director of the Policy Development and Review Department responded that the status of bilateral contributions had not changed materially since the informal luncheon discussions with Directors at the time of the spring meetings. He had no indications of any significant additional commitments from bilateral creditors; those still ranged from SDR 1.2–1.3 billion through SCA-2 transfers or through other mechanisms, amounting to about half of targeted SDR 2.5 billion that the Fund was seeking from bilateral contributors for the ESAF-HIPC Trust. Even at current prices, if the Fund had sold 5 million ounces of gold on its originally planned schedule, the interest from the proceeds of those sales would have generated subsidies on an as-needed basis of about SDR 1.3 billion. While gold sales would provide additional resources for the ESAF-HIPC Trust, some bilateral contributors had stated that they would review their contributions if the Fund sold gold, implying that they might possibly reduce their contribution as a result. Other bilateral contributors had indicated that they would not consider making contributions unless there were a package including gold sales, meaning that bilateral contributions might increase as a result of gold sales.

Mr. Mirakhor wondered whether the Fund should not therefore remove the remaining uncertainty and move toward selling less than 5 million ounces of gold, given that the opportunity cost of not doing so was rising. He agreed with Mr. Shaalan that the uncertainty surrounding financing of the interim ESAF and the HIPC Initiative should be resolved as soon as possible.

The Director of the Policy Development and Review Department responded that the Board would have to decide that issue.

Mr. Donecker commented that any rush to sell gold would result in further complications. It remained a sound approach for the Fund first to seek to maximum bilateral contributions. If other countries contributed as Germany had done, the ESAF-HIPC Trust would be financed without the need for gold sales.

Mr. Shaalan remarked that the Director's comments appeared to indicate that bilateral contributions were at a standstill. If the Board wished to see progress with the HIPC Initiative, it should expedite the sale of gold, as Mr. Mirakhor had suggested. For such an important initiative, the current uncertainty was unacceptable.

Mr. Newman asked whether the forthcoming costing paper on the HIPC Initiative would reopen the question of how that initiative would be financed.

The Director of the Policy Development and Review Department noted that the range of cost estimates in the paper would be fairly wide, but that the costs of the Initiative would fall somewhat. While the staff would not present scenarios involving a 90 percent debt reduction by the Paris Club, it would present ones including various burden-sharing assumptions in light of Board discussions since June 1996. The different assumptions resulted in a relatively wide range of costs for bilateral and multilateral contributors, including for the Fund. The staff's best estimate of the cost of the HIPC Initiative to the Fund would be a function of the outcome of the burden-sharing discussion. That being said, the costing paper would present scenarios assuming that all eligible countries would receive assistance under the Initiative, and scenarios based on various targeted ratios of the net present value of the ratio of debt to exports. In its June 1996 statement (BUFF/96/70), the staff had presented cost estimates based on a simplified assumption that 200 percent would be the target. In the HIPC cases that the Board had considered thus far, a 200 percent target was outdated.

Mr. Chelsky remarked that, in considering the staff's current proposal, it was important to find some means of better targeting Fund support for commercial DDSR operations by the most heavily indebted countries. All avenues for doing so should be investigated. He wondered whether or not there was scope within the ESAF-HIPC Trust to allocate resources for commercial DDSR operations, or to earmark bilateral contributions to that end, as was the case in the World Bank, where contributions could be earmarked to a specific country or specific institution. He would not yet preclude the possibility of establishing a small facility to provide concessional resources on terms identical to those of the ESAF for supporting members' commercial DDSR operations.

Mr. Mirakhor commented that earmarking of resources under the ESAF-HIPC Trust for DDSR operations would not surmount one problem noted by Mr. Chelsky, namely, the perception that the Fund was using scarce concessional resources to bail out commercial banks.

Mr. Chelsky responded that his suggestion on earmarking had meant to convey the point that there were other avenues that could be pursued, each with their own advantages and disadvantages. For example, if a separate facility were established for supporting DDSR operations in countries qualifying for the HIPC Initiative, that facility would not effectively be financed by ESAF resources given the fungibility of internal and external resources in the Trust. The resources could be considered bilateral; the bilateral contributors would have to justify to their respective constituencies why they were allocating their resources in that manner. His point was that other options could be considered besides the staff's current proposal.

Mr. Yoshimura commented that uniformity of treatment was an important principle, which should not be compromised in the case of Vietnam. Vietnam was eligible and met the conditions required under the staff's proposal.

Mr. Grilli remarked that he found it difficult to reconcile the important principle of uniformity of treatment with that of eligibility. To his understanding, whenever the Fund created a facility, it discriminated among members in specifying that only countries with certain income levels, for example, could qualify for assistance under the facility. Members with different needs could justifiably be treated differently than other members. It was unclear why such differential treatment could not be extended to a subset of countries that were eligible for ESAF. While the staff representative from the Legal Department had rightly emphasized that the criterion for use of ESAF resources was a protracted balance of payments problem, the Fund had interpreted that criterion elastically; the institution had exercised judgment and approved ESAF arrangements for countries that evidently had not had protracted balance of payments problems. He wondered why the Fund could not also use such judgment with regard to the use of ESAF resources for commercial DDSR operations.

The staff representative from the Legal Department had noted correctly that there was no restriction in the current ESAF Trust Instrument on the use of the ESAF for DDSR operations, Mr. Grilli said. Whereas the staff's proposal imposed additional demands on the ESAF, the proposal of Messrs. Bernes and Chelsky sought to limit continued increases in demand on the ESAF—resulting from the staff's proposal—not to limit access to the existing ESAF Trust Instrument. Indeed, the Fund could limit uncertainties regarding ESAF resources both on the supply (financing) side of the facility and the demand side, in terms of the number of countries that could request such financing. The ESAF-HIPC Trust was not fully financed, yet the Fund was proposing to allow additional demands on that facility while at the same time expressing concern about the status of its financing. While he did not fully agree with the proposal by Messrs. Bernes and Chelsky, it was a legitimate proposal, which sought to limit additional demands on the ESAF-HIPC Trust and to target ESAF resources on a number of countries. The proposal by the Canadian chair made good sense and did not represent a violation of uniformity of treatment.

The Director of the Policy Development and Review Department noted that Executive Directors did not seem to agree on the objective of the staff's proposal. Under the debt strategy, most middle-income countries—other than a few remaining cases which were close to agreement—had dealt comprehensively with their commercial bank debt. The Fund had already helped finance the up-front costs of DDSR operations by middle-income countries, through set-asides or augmentations under Stand-By or Extended Arrangements, involving resources from the General Resources Account (GRA). A number of low-income countries had dealt with their commercial debt through straight buybacks under the IDRF, in which large discounts had been provided. Other low-income countries were either still discussing debt-reduction operations or had just started such discussions with commercial bank creditors. In a few of those cases, full application of the IDRF, support from donors, and use of the countries own resources might prove insufficient to finance the up-front costs of DDSR operations, given the secondary market prices of those countries' debt and the size of the debts. Given those costs, it had become increasingly apparent—especially as discussions with commercial creditors had proceeded—that low-income countries' debt operations would involve not straight buybacks at large discounts, but rather menus of options similar to those used by middle-income countries.

In that context, the staff had considered whether the Fund should assist low-income countries with the up-front costs of DDSR operations with resources from the ESAF rather than from the GRA, the Director continued. As the staff representative from the Legal Department had noted, the Fund had not previously financed DDSR operations with ESAF resources because of the concerns of several Executive Directors about the use of concessional resources to finance DDSR operations with commercial creditors, and because of the limited amount of ESAF resources. While the staff was as concerned as Directors at the fact that the ESAF-HIPC Trust was not fully financed, the remaining number of low-income countries needing Fund support for DDSR operations had shrunk to only a few, with resulting limited costs to the Fund. From that point of view, the staff had reconsidered the previous approach of not using ESAF resources for commercial DDSR operations. The staff's objective thus was to support the remaining few ESAF-eligible countries with commercial DDSR operations—but not with GRA resources.

In view of the debt situations of ESAF-eligible countries, the Board seemed to have agreed, at the least, that it would be inappropriate to finance DDSR operations of ESAF-eligible countries with GRA resources, the Director noted. If the Board believed that the objective should be to assist only countries qualifying for the HIPC Initiative, that could be done; however, it would require the establishment of a new facility, new funding, an 85 percent majority of the voting power in the Board, and the consent of all ESAF creditors. In other words, it would require far more substantive changes to Fund procedures than the staff's proposal of simply extending the existing powers under the ESAF to use ESAF resources for DDSR operations by ESAF-eligible countries (just as GRA resources had been used since 1989 to support DDSR operations by middle-income countries eligible for Stand-By and Extended Arrangements). Perhaps the objective of the staff's proposal had become confused with the HIPC Initiative because the Board was considering at the same time the eligibility of several countries—especially Côte d'Ivoire—for the Initiative.

If the Board approved the staff's proposal, as opposed to that of Messrs. Bernes and Chelsky, it could then consider whether or not Vietnam would receive ESAF resources for its DDSR operation with commercial creditors, the Director added. The potential DDSR operation in Vietnam had been under discussion for a long time, with clear indications on how the operation would be financed. The staff's position was, and remained, that the operation should continue as had been intended, in line with the original understanding that its up-front costs could be financed through IDA, donor, and Vietnam's own resources. It would not make sense to include Fund financing of the operation if it resulted in a substitution of less-concessional ESAF resources for more concessional IDA resources, which the Bank had indicated would be available. The staff's approach to Vietnam was based on the best interests of both the Fund and Vietnam.

The staff representative from the Legal Department, noting Mr. Grilli's query whether the creation of a new facility per se effectively discriminated among members, responded that the principle of uniformity of treatment in such a case applied within the facility. All ESAF-eligible members, for example, were treated uniformly under that facility. In creating a number of facilities, such as the Compensatory and Contingency Financing Facility, the Systemic Transformation Facility, and the Buffer Stock Facility, the Board had established a special policy under each facility—as allowed by the Articles—specifying objective criteria for the provision of support under the facilities. In some cases, such as the ESAF Trust Instrument, a list of more than 80 eligible countries had been included (annexed to the decision that established the Structural Adjustment Facility).

To his understanding, the IDA Debt Reduction Facility (IDRF) made no distinction between different categories of members under that facility, the staff representative pointed out. All IDA-eligible members had equal access to the facility, provided that they met the criteria under the trust instrument of the IDRF.

Mr. Donecker wondered why the Fund could not also stipulate objectively that only ESAF-eligible countries with debt discounted by 70–80 percent—or only heavily indebted poor countries, for example—would be eligible for ESAF support for DDSR operations.

The staff representative from the Legal Department responded that such a stipulation would change the eligibility criteria under the existing ESAF Trust Instrument, as established in 1987.

The Director of the Policy Development and Review Department commented that the objective criteria describing a HIPC differed from those describing an ESAF-eligible country. Under the existing ESAF Trust Instrument, it was not possible to differentiate HIPCs and other ESAF-eligible countries without first establishing a new facility, requiring an 85 percent majority of the voting power, and the consent of all contributors (if the new facility were to be financed out of the existing ESAF Trust Instrument, which would change the agreed purposes of the Instrument). By contrast, the staff's proposal to use ESAF resources for the DDSR operations of ESAF-eligible countries simply represented an extension of powers under the existing Instrument (the eligibility criteria of the ESAF were not changed as a result).

Mr. Grilli wondered whether targeting of ESAF resources for specific purposes—as under the proposal of Messrs. Bernes and Chelsky—was incompatible with the general purposes of the ESAF. Under the staff's proposal, the Fund would differentiate between ESAF-eligible countries indebted to commercial banks versus those that were not. Perhaps the additional resources that ESAF-eligible countries would access for DDSR operations, under the staff's proposal, would differ little from the creation of a new facility, or a special lending window. Like the proposal of Messrs. Bernes and Chelsky, the staff's proposal also targeted the use of ESAF resources and resulted in additional access to the ESAF.

The Director of the Policy Development and Review Department responded that a few ESAF-eligible countries had balance of payments needs associated with forthcoming DDSR operations. The IDRF—which was more concessional than the ESAF—had been designed to support such operations for low-income countries when the debt concerned was highly discounted in secondary markets. The IDRF had supported successfully DDSR operations by 12–13 countries. However, there remained a few other countries whose discounts were not large enough and IDA grant resources not sufficient to finance their DDSR operations with commercial banks. The staff had thus reopened the question of whether or not the Fund ought to take into account the balance of payments demands created by possible DDSR operations in determining access under the ESAF in those few case in which the IDRF would not be sufficient and GRA resources would be inappropriate (too costly for low-income countries). The staff was proposing that the Board modify its previous policy decision, which had been taken in light of the expectation that the IDRF would be sufficient to finance the DDSR operations of low-income countries.

Mr. Chelsky questioned whether GRA resources would be inappropriate for a few low-income countries' DDSR operations with commercial banks. GRA resources for DDSR operations would not exist in isolation, but would be provided as a package including IDRF resources, substantial bilateral resources, and countries' own resources. What mattered for a country's balance of payments need was the concessionality of the overall package, not of its individual components. It should be kept in mind that GRA resources were generally on better terms than the countries could obtain from other sources.

The Director of the Policy Development and Review Department commented that it was a matter of judgment. On the one hand, if the objective was to support the DDSR operations only of countries qualifying for the HIPC Initiative, that would be possible with the establishment of a new facility. On the other hand, if the objective was to support DDSR operations in countries that the Fund had already designated as requiring concessional resources—the ESAF-eligible countries—which needed somewhat more ESAF resources given their DDSR operations, then those concessional ESAF resources would more appropriate than GRA resources.

Mr. O'Brien wondered whether the staff was asking the Board to remove the qualification that it had imposed on the use of ESAF resources, namely, against the use of ESAF resources for DDSR operations by IDRF-eligible countries.

The Director of the Policy Development and Review Department remarked that there had been an expectation that the IDRF would prove sufficient to finance the DDSR operations (high-discount debt buybacks) of low-income countries with commercial banks. That had been the case with most low-income countries, but would not be the case with a few remaining countries; hence, the staff's current proposal to use ESAF resources to support DDSR operations in the latter.

Mr. Grilli asked whether the Board's earlier qualification on the use of ESAF resources for DDSR operations had been made before or after the establishment of the IDRF.

The Director of the Policy Development and Review Department said that the issue of the IDRF proving insufficient to finance all of the DDSR operations of low-income countries was a new one. When the Bank had established the IDRF, there had been some discussion as to whether or not the Fund would assist countries with DDSR operations under that facility. The Fund had noted at that time that it had the ability to help finance such operations in low-income countries, as it had done with GRA resources for middle income countries with Stand-By or Extended Arrangements. It had been decided that the IDRF, in combination with bilateral contributions, would finance the DDSR operations of the low-income countries. In the event, no requests had been made for support through ESAF resources until recently, with a few remaining cases needing DDSR operations with their commercial banks.

Mr. Barro Chambrier remarked that the Director of the Policy Development and Review Department had made two vital points, which the Board should not overlook. First, the staff's current proposal had not been made in the context of the HIPC Initiative, but in the context of the need to normalize low-income countries' relations with commercial creditors. Second, the additional costs to the ESAF of helping the remaining few low-income countries to normalize their relations would be strictly limited (the proposal of Messrs. Bernes and Chelsky would only exclude two countries from receiving ESAF support for their DDSR operations). While the legal stricture that the Fund could not discriminate between eligible members under an existing facility was critically important, it was separate from the overriding concern, namely, that the additional costs to the ESAF-HIPC Trust of Fund-supported DDSR operations in low-income countries should be limited. The latter concern was the operative one and had been dealt with in the staff's current proposal.

The Acting Chairman noted that the proposal of Messrs. Bernes and Chelsky, to limit ESAF resources for DDSR operations to countries qualifying for the HIPC Initiative, would require the establishment of a new facility, with an 85 percent majority. Moreover, as Mr. Barro Chambrier had emphasized, the proposal by Messrs. Bernes and Chelsky would only exclude two of the countries that might need ESAF support for their DDSR operations, for a maximum saving of about $37 million.

Mr. Donecker emphasized that, while his authorities would need more time to consider the staff's legal opinion, they would certainly be opposed to the establishment of a new facility. Each country had only one balance of payments need, and a range of facilities were already in place to meet that need. He questioned whether, at the time of the creation of the ESAF, formerly the SAF, that contributors had anticipated that a portion of their contributions would be used to bail out commercial banks, in the words of some observers. It was important to bear in mind the good faith of the contributors to the ESAF, who had focused on supporting active restructuring and macroeconomic policies leading to more sustainable balance of payments, not potential bail-outs of commercial banks.

Mr. Chelsky indicated that there were other modalities that could be considered than the proposal of the staff and his chair, to limit the costs to the ESAF-HIPC Trust of supporting DDSR operations in low-income countries. For example, a trust fund could be used for voluntary contributions, in order to make GRA resources for DDSR operations more concessional for low-income countries.

Ms. van Geest noted that all contributors to the ESAF would have to approve a new facility to finance DDSR operations, yet one contributor had already indicated that it would not support creation of a new facility. It would thus not make sense to pursue further the proposal of Messrs. Bernes and Chelsky. That being said, she would be interested in the reasons that the World Bank had stated recently that IDRF resources would be insufficient to finance DDSR operations. Her authorities would only be willing to use ESAF resources for DDSR operations in low-income countries if IDRF resources were insufficient.

Mr. Taylor said that he needed more time to consider the legal ramifications of the proposal by Messrs. Bernes and Chelsky.

Mr. Yoshimura added that he too needed more time to consult his authorities on the legal issues, the case of Vietnam, and any differences between the Fund and Bank, especially as Japan was the main contributor to the ESAF.

Mr. Autheman commented that the current discussion should be continued, rather than concluded at present on the basis of only some Directors' comments.

Mr. Newman wondered whether the staff representative from the World Bank would explain why the Bank believed that the Fund should participate in Vietnam's DDSR operation, and more generally in such operations when IDA credits were not available or sufficient.

Mr. Yoshimura seconded Mr. Newman's question, and asked whether the Bank had insufficient resources to finance Vietnam's DDSR operation.

The staff representative from the World Bank commented that the Bank's position in the case of Vietnam was similar to its position on DDSR operations generally, in emphasizing the importance of appropriate burden-sharing among contributors to DDSR operations. The Bank had emphasized that principle in all DDSR operations, particularly in regard to the Fund, given the latter's participation in similar operations in the past. The Bank believed that the Fund's participation in the case of Vietnam and other cases was important. However, he could not comment on the financing of the Vietnam operation, as it was under consideration again, and would depend in part on the decision of the Fund Board. The Bank had made no final decision, pending the decision of the Fund Board.

Mr. Yoshimura and Mr. Newman asked why Fund participation was necessary in the case of Vietnam. They wondered whether there was a financing gap to be filled by the Fund, or whether the Bank was simply insisting on Fund participation.

The staff representative from the World Bank said that the Bank strongly favored burden sharing in DDSR operations. While it was currently reviewing its financing in the event that the Fund did not support Vietnam's DDSR operation, it had not yet made any decisions.

The Director of the Policy Development and Review Department added that the DDSR operation in Vietnam had been under discussion for a long time. Indications had been given that the combination of Vietnam's own resources, and bilateral and IDA contributions would be sufficient to finance the operation.

Mr. Chelsky asked whether the Executive Board of the World Bank had been consulted yet on whether or not the Bank would contribute to Vietnam's DDSR operation in the absence of Fund support.

The staff representative from the World Bank responded that, to his knowledge, the Board in the Bank had not yet discussed the matter.

Mr. Kiekens wondered if the Bank had any clearly defined criteria defining appropriate burden-sharing between IDA and the Fund. Moreover, if the Fund agreed to the use of ESAF resources for DDSR operations, he wondered if that would change IDA policies as well, or prompt a review by IDA of its burden-sharing practices.

The staff representative from the World Bank responded that burden-sharing was decided on a case-by-case basis. While the IDA would not formally review the criteria it used in deciding whether or not to participate in DDSR operations, discussions would be ongoing between Bank and Fund staff on the appropriate amount of financial support by each institution for each DDSR operation.

Mr. Kiekens wondered if the Bank set an upper limit to its financing according to certain criteria, or whether it decided case-by-case on the financing to be provided.

Mr. Newman wondered why the Bank felt that burden-sharing was especially important in the case of Vietnam.

The staff representative from the World Bank responded that most DDSR operations had been supported by the Fund. In the case of Vietnam, the Bank believed that if resources were available for financing DDSR operations, then they should be used. Many considerations were involved in the decision-making process on how much financing to provide for a country's DDSR operation, which was subject to negotiation between the Bank and the country.

Mr. Autheman indicated that, before the cases of Vietnam and Côte d'Ivoire had arisen, all Bank DDSR operations had been financed entirely from a special facility funded by Bank net income. Unlike the cases of Vietnam and Côte d'Ivoire, the previous cases had all involved relatively small debts, thus modest Bank financing—consisting of grants—and bilateral contributions. In that context, it would not be helpful to try to identify burden-sharing rules in a new situation, such as in the cases of Vietnam and Côte d'Ivoire.

Mr. Kiekens remarked that he had been surprised to hear that the World Bank did not have a formal policy on financing DDSR operations, other than case-by-case assessments. One of the major conclusions of the Board's previous discussion on ESAF support for DDSR operations (EBM/97/35, 4/9/97) had been that Fund financing of those operations should be strictly subsidiary to IDA financing, and that it only be used as a last resort. In that light, he wondered how the Fund could judge its support in the future without clear IDA policy rules and without the institution becoming subordinated to policy decision by the Bank or IDA.

Mr. Chelsky commented that, to his understanding, the Bank's proposed DDSR operations in Vietnam and Côte d'Ivoire would be discussed by the Board of the World Bank without any discussion on the Bank's policy on using IDA resources for commercial DDSR operations. If that was true, it suggested that the Bank was not constrained in using IDA resources for DDSR operations. In light of the comments of some other Directors, he wondered therefore if there was any rationale for the Fund to be participating in DDSR operations other than with GRA resources.

Mr. Grilli added that the Bank staff paper on Côte d'Ivoire had envisaged ESAF support of SDR 70 million.

Mr. Yoshimura asked for confirmation that the Bank would not provide IDA resources if the Fund provided GRA resources for DDSR operations by low-income countries.

The staff representative from the World Bank confirmed that the Bank had indicated that it would not provide IDA resources if the Fund provided GRA resources (footnote 29, page 13, EBS/97/94), which was consistent with the general policy that countries benefiting from DDSR operations financed by the IDRF should not borrow on hard terms. Mr. Grilli was correct that the Bank indeed expected ESAF financing to be available for the DDSR operation by Côte d'Ivoire.

Mr. Donecker commented that GRA resources incorporated a substantial concessional element, and were not on hard terms. None of the countries potentially benefiting from GRA resources could hope to obtain market financing on as good terms as the GRA allowed. The Fund could provide Côte d'Ivoire with GRA resources on concessional terms, compared to market terms.

Mr. Yoshimura added that GRA resources had already been used together with IDA resources.

The Director of the Policy Development and Review Department commented that GRA resources had never been used in conjunction with IDRF resources for DDSR. operations in low-income countries—unlike the case of middle-income countries. In low-income countries, the IDRF had financed DDSR operations only together with bilateral contributions and the countries' own resources.

The Bank was moving toward a situation in which its grant resources under the IDRF would be insufficient to fully fund the up-front costs of debt buy-backs by countries that had already reached agreements with commercial creditors, the Director stated. To finance the larger up-front costs and smaller discounts on the debt of the few remaining countries, the Bank was thus considering financing some of those DDSR operations with IDA credits, or a mix of IDA grants and credits. The staff had not seen any policy paper by the Bank on the issue, but had been informed by the Bank staff of Bank management's views as the institution moved to finance DDSR operations with IDA credits.

It was correct that there had been no discussion under the SAF, or at the time that the Fund had mobilized resources for the ESAF in 1986–87, of potential use of ESAF resources for DDSR operations with commercial banks, the Director recalled. It was unquestionable, nevertheless, that ESAF resources would only be used for such operations under programs of appropriate conditionality, with strong policies aimed at the objectives that had led to the creation of the ESAF.

The Acting Chairman said that, at the current discussion, the rest of the Board should indicate its views on the staff's proposal. After it had had more time to consider the legal ramifications—particularly of the proposal by Messrs. Bernes and Chelsky—it could then return for a subsequent discussion to decide on the staff's proposal.

Mr. Grilli made the following statement:

In the Board Meeting held last April, I expressed our strong reservations on the use of ESAF resources for Debt and Debt Service Reduction operations, because it would have raised problems of affordability, problems of efficacy, and problems of purpose. After having read the new document presented by the staff, my reservations still remain.

In the paper the staff asks a very direct question, i.e. whether or not Directors agree with the proposed use of ESAF resources for DDSR operations. In light of what we said in the past and this morning during the discussion of the Canadian proposal, it will not come as a surprise that we cannot agree to this special use, as envisaged in the staff paper.

First and foremost, I cannot agree with the staff proposal because I have strong reservations on its merits. In a nutshell, the rationale behind it is that the reduction of the stock of external debt to a more manageable level directly improves the growth outlook of a country. This relationship is not only too mechanic and simplistic in itself, but it is also challengeable empirically. A positive relationship is shown to exist between good policies and economic growth, but not between reduction of debt burdens and good policies. This is the missing nexus, which the proposal takes for granted (at least implicitly), but for which there is no theoretical basis and, to my knowledge, no convincing empirical evidence.

When ESAF was established in 1987, we all welcomed this new instrument because it would have enabled the Fund—and I am quoting from the Chairman's Summing Up (EBM/87/171)—"to play an active role in promoting and supporting economic policy adjustment in [ESAF countries], thereby contributing to the achievement of higher growth and a resolution of the severe debt and other problems that many of these countries are facing." The causality was then clear: sound macroeconomic policy in conjunction with market-oriented reforms, by removing structural impediments, would have fostered economic growth thus reducing the burden of the external debt. After ten years, in light of the approval of the HIPC Initiative and of today's proposal, the causality among good policies, growth, and debt reduction seems to have been reversed. I have the strong feeling that the emphasis has shifted from the soundness of economic policies to the reduction of external debt per se. And this is a giant step backward. In this regard, I cannot but share the concerns expressed by Mr. Bernes and Mr. Chelsky in their statement about the lack of any link in the staff proposal between the possible access to ESAF resources to finance debt and debt service reduction operations and the nature or strength of the conditionality attached to the use of such highly concessional and limited resources. The proposal put forward by our two colleagues had the additional merit of limiting this exceptional use of ESAF resources to the case of HIPC operations, i.e. to those Fund-supported programs that are expected to be among the "stronger ESAFs." All of this is missing in the staff proposal.

Secondly, the direct pursuit of commercial debt and debt service reduction operations using public and concessional resources raises critical issues of propriety in their use. We are in effect using not credit resources (like in the original Brady schemes), but grant-like resources, originally designed to alleviate structural balance of payments problems, to "bail out" commercial banks in certain countries. The original strong presumption that ESAF resources should not be used for DDSR operations was solidly rooted in these grounds as well.

Furthermore, I wonder whether the proposed use of ESAF resources might represent a new policy, or a "special window" within the general framework of the ESAF. In fact, part of the ESAF resources would be allocated to address a very specific balance-of-payment problem, i.e. the service of a country's debt vis-à-vis commercial banks and nonstructural impediments (structural impediments have to do with the values of exports and import propensities, capital inflow regimes, etc., not the effects of past bad decisions concerning commercial borrowing). In addition, if I have understood correctly, the use of ESAF resources for debt and debt service reduction operations would come over and above the existing guidelines of access. All three of these elements—specific use, nonstructural purposes, and additionality—represent significant changes with respect to the original purposes on the basis of which member countries decided to contribute to the financing of the ESAF Trust. This induces me to believe that a simple Board majority should not be sufficient to decide on the establishment of a "specific window" and that the consent of all ESAF-creditors should be sought, at least until a self-sustained ESAF is established. Even if it were not considered a strict legal requirement, a unanimous decision by creditors would be in my view a matter of strong opportunity in a case like this.

Finally let me say I was very puzzled by the fact that while the Board of the Fund has yet to decide about the possible use of ESAF resources for debt and debt service operation, a paper on a commercial debt restructuring program for Cote d'Ivoire already circulated in the World Bank envisages a Fund contribution of 70 million dollars through an ESAF loan (the same reported in Table 1 of today's staff document as illustrative). Are Board discussions considered a formality? I do not believe they are, and I am sure that you don't either. These episodes should therefore not occur again.

Mr. Autheman stated that, to his understanding, there was no clause in the ESAF Trust Instrument forbidding the Fund from recognizing a balance of payments need derived from the settlement of commercial debt. Nonetheless, there had been an understanding (as opposed to an "expectation" or a "qualification") that the Fund would not have to finance such a need. That understanding had been based, in part, on the expectation that other resources would be sufficient to finance fully such balance of payments needs. The latter could be addressed within the traditional flexibility of access policy—but only as long as the Fund remained within the access limits and as long as it complied with two guiding principles. First, the Fund had to adhere to the principle that the level of access depended on the balance of payments need, of which there was only one, as Mr. Donecker had correctly emphasized. Second, the Fund had to adhere to the principle that the level of access also depended on the quality and strength of the program to be supported.

The traditional instruments used to finance reduction of commercial debt of ESAF- and IDA-eligible countries were insufficient to cover the financing required under the expected agreements with commercial banks, Mr. Autheman said. The relevant question thus was whether or not the Fund should contribute—after IDA had done so—as a last resort to bridge the financing gap by increasing access. It was clear the IDA was willing to contribute to such DDSR operations, but thus far unclear whether the Fund would do so as well. He would not go so far as to suggest that the Fund establish a formal new policy on supporting DDSR operations with ESAF resources; rather, it would be sufficient to agree on a new understanding that would keep the Fund's options open, enabling it to address each case as it arose with appropriate flexibility. The latter would imply a readiness to support DDSR operations, though such readiness would be acted upon only if the Fund was confident that the agreed discount was sufficiently deep; if the level of the need could demonstrably not be met through the full use of traditional instruments; and if the Fund was confident that the agreed program was of sufficient quality and strength to merit the proposed access. In short, he did not see any pressing need for the Board to choose, at present, among the three modalities for providing ESAF support for DDSR operations. It was important that any decision to provide such support should be taken at the same time as the Board approved the relevant ESAF arrangement of proper quality. That being said, he preferred to some extent the most pragmatic modality—not requiring a redrafting of the ESAF Trust Instrument—the one allowing for flexible access within a three-year arrangement. Nonetheless, given that there would always be some uncertainty whether or not a commercial debt agreement would materialize, it would be fair to stipulate that the country not use all of its authorized access unless the agreement materialized.

While he understood the starting point of the proposal by Messrs. Bernes and Chelsky, namely, to limit use of resources in the ESAF-HIPC Trust, he could not agree with the change in the ESAF Trust Instrument that would be required as a result, Mr. Autheman stated. Furthermore, he had a major difficulty with one of the assumptions of the proposal by Messrs. Bernes and Chelsky, that Vietnam's DDSR operation should be excluded a priori from support under the ESAF. While there was no reason to exclude, a priori, some ESAF-eligible countries from such support, the Fund, nevertheless, had to indicate clearly to IDA that it was ready to intervene as a contributor of last resort. That did not imply that the Fund should be asked to contribute in all cases. If a previous understanding had been reached between the Fund and IDA staffs that a Fund contribution of last resort might be needed in some cases, but that IDA would—in the case of Vietnam—have the ability to finance the DDSR operation, then that understanding should be adhered to. While he had no difficulty supporting the stance of the Director of the Policy Development and Review Department, the Board should be able to reserve judgment on whether or not the Fund should, in the final analysis, contribute to Vietnam's DDSR operation.

For the ESAF countries eligible for the HIPC Initiative, it would be reasonable to assume that the increased access granted to help finance DDSR operations should meet those countries' need for interim financing, Mr. Autheman considered. While that presumption would need to be verified in each case, it would provide a simple means of delivering interim financing.

Mr. Disanayaka made the following statement:

We thank the staff for presenting a comprehensive paper on the proposed use of ESAF Resources for Commercial Debt and Debt Service Reduction Operations, in response to requests made by several of our colleagues at the last Board discussion of this matter in April this year. In this paper the staff has further clarified the rationale for considering the use of ESAF Resources for Commercial DDSR operations of a selected group of low-income countries, the possible modalities for such use and a rough estimate of the funding that would be required. In view of the uncertainty surrounding the mobilization of adequate resources for interim ESAF operations and also the very limited nature of such funding even if we succeed in securing an appreciable volume, we would caution that the use of such limited resources for the above purpose be undertaken with great care. Such use therefore has to be limited to a few cases of ESAF-eligible low-income countries in which IDA Debt Reduction Facility and DDSR IDA credits combined with donors and members own resources would not be sufficient for their commercial debt reduction. The ESAF Resources to be used should be complementary to these sources of funding and should be used in conjunction with the same, maintaining the spirit of equitable burden sharing. Moreover, as the staff have argued in the paper, use of ESAF resources should be limited to cases requiring a menu of options in the context of Brady-style DDSR operations which meet the test of efficiency and that they should not be provided for straight buy-backs for which there are already existing funding mechanisms.

With regard to the modalities for Use of ESAF Resources, we would prefer the third option as it appears to be the most flexible of the three suggested. We would accordingly favor amendment of the ESAF Trust Instrument to give effect to this formula.

As regards claiming credit under the HIPC initiative for Use of ESAF Resources for Commercial DDSR, we would feel that, like the World Bank, the Fund too should not claim such credit as it would unnecessarily limit the operation of the facility to countries in the second stage of HIPC Initiative. We would prefer the extension of it to other deserving countries as well.

To sum up we would agree, in principle, with the proposed use of ESAF Resources for commercial DDSR operations in the case of a limited number of low-income countries under the criteria specified in the paper. We would however have some concerns about the timing of the use of this mechanism. As we have already pointed out, we have not yet succeeded in securing a critical mass of funding for the interim ESAF operations. Despite this, we have decided to go ahead with the implementation of the HIPC Initiative. Now we are trying to take a further step into another area, i.e., commercial DDSR operations. We entertain our concerns despite the estimated funding for these operations would at this juncture appear modest. As the HIPC initiative itself (to which we have already committed) would take a substantial portion of resources from the interim ESAF we would urge that a firm commitment on commercial debt reduction be made after getting a clearer picture of the availability of resources for the Interim ESAF operations. Otherwise, we would not be fair by the large number of nondebtor ESAF-eligible countries who are looking up to the Fund for continued support for their adjustment programs in the interim period.

Mr. Han made the following statement:

We welcome this further discussion of the use of ESAF for Commercial Debt and Debt Service Reduction (DDSR) operations and commend the staff for their illustrative paper responding to earlier questions.

Eventually resolving the debt problem, which has long trapped the developing world, will help these countries join in the ongoing financial globalization process. Their participation deserves more attention from the international community. This chair supports the proposed use of ESAF resources for commercial DDSR operations as it conforms to ESAF objectives and, as staff explain, is in a more efficient way.

In view of the already high demand on ESAF resources, I share the staff's view that the Fund's ESAF contribution for commercial DDSR operations should continue to be in the range of one-fourth to one-third of the up-front cost of the operations, serving as a catalyst rather than a cure-all. And, as was suggested in the previous statement of this chair on this issue, we hope a case-by-case approach could be followed to ensure the self-sustainability of ESAF resources.

With regard to modalities for this operation, we support the third option proposed by staff. In this option, the pledges from the Fund and the Bank should be attractive enough to bring the indebted members and their commercial creditors together for discussion of commercial DDSR operations. So this option's disbursement arrangements could expedite operations to materialize. In the case where an anticipated DDSR operation does not take place, this option could minimize the possible loss incurred to both the Fund and the indebted member. In the revision of the ESAF Trust Investment, it is hoped that cost implications, such as the commitment fees, could be included.

We also agree with the staff's point that the use of ESAF resources for commercial DDSR operations should be open to all ESAF-eligible members rather than limited to countries in the second stage under the HIPC Initiative. Therefore, this chair takes the position that the Fund should not seek to claim credit under the HIPC Initiative for this use of ESAF resources.

Mr. Cippa made the following statement:

We thank the staff for providing further information on the possible costs of using ESAF resources for commercial debt and debt service reduction (DDSR) operations and on some operational modalities for such a use.

In our previous discussions, we argued that financing DDSR operations in favor of low-income countries with resources from the General Resources

Account would be inappropriate. Non-concessional financing would not be consistent with the objective of the HIPC Initiative of achieving debt sustainability.

Therefore, we accept the use of ESAF resources for commercial DDSR operations. However, it must be clear that this use should not become an excessive burden on ESAF. A cautious approach is particularly warranted, in view of the still unclear financing of the Fund's participation to HIPC. The use of ESAF resources should, strictly be restricted to the few cases where IDA financing and resources from donors and the country are not sufficient to finance the up-front cost of a Brady-style operation.

When participating in a DDSR operation, the Fund's contribution should be limited. Mr. Bernes and Mr. Chelsky propose to limit eligibility. Like others, I would also like to have more written information on the legal aspects of limiting eligibility only to HIPC countries. I would therefore leave this issue open. Meanwhile we could try to economize on other grounds. As we previously stressed, the World Bank should continue to assume the leading role in commercial debt reduction. If a country's own resources and IDA financing are not enough to cover the cost of the operation, the country should first turn to bilateral donors. Should the mobilized resources still be insufficient, only then should the Fund participate. Therefore, we do not agree with the staff's proposal to generally set the Fund's contribution in the range of one-fourth to one-third of the up-front cost of an operation.

This range corresponds to the Fund support in DDSR operations in favor of middle-income countries. ESAF eligible countries have access to IDA resources and to grants from bilateral donors, which wealthier countries are excluded from. For this reason, the possibilities offered by these sources of finance should be exploited in full before much less concessional ESAF funds are used. The use of ESAF resources should thus be strictly subsidiary to the use of IDA and bilateral financing. The Fund range of support in DDSR operations in favor of middle-income countries should therefore rather be interpreted as a cap for operations in favor of low-income countries. Alternatively, this ceiling could be defined as a proportion of quota.

We think that the case of the HIPC countries warrants a separate treatment among the ESAF eligible members. They are offered to participate in the HIPC Debt Initiative of the Fund an the World Bank. The Fund would therefore contribute twice: first, if the HIPC country can not mobilize enough resources for its commercial debt rescheduling through the channels already at its disposition today and second, if the country will later decide to participate in the HIPC Debt Initiative. As already had been mentioned during the last discussion, the usefulness of commercial debt reduction operations in HIPC countries as such can be questioned, given the fact, that the HIPC Initiative request the commercial creditors to provide at least comparable treatment as the Paris Club, i.e., debt reduction of up to 80 percent. In financing debt reduction operations (and "taking over"the discounted commercial debt), the multilateral institutions—besides reducing their own debt—contribute to debt reduction measures in the "commercial debt-window," which, by rights, should be provided by the commercial banks. Unfortunately, the staff report does not elaborate on this.

Under these circumstances we think that the grant element of such a debt reduction operation supported by ESAF resources in HIPC countries should be considered in defining the contribution of the Fund if the country later decides to participate in the HIPC Debt Initiative. The staff's argument that the World Bank is not deducting such grant elements if it is extending resources through its IDA DDSR credits and IDA Debt Reduction Facility is not convincing. The Fund's and Bank's situation cannot be compared. The Fund's involvement in commercial debt reduction through ESAF must be of a strictly subsidiary nature. On the other hand, commercial DDSR operations through the IDA should be basic elements of the World Bank's policy toward low income countries. At least that was our understanding until today. Like Mr. Kiekens, we are somewhat surprised to hear from the World Bank representative that no IDA policy or guidelines exist, and that each operation is decided on a case by case basis. The burden sharing issue should be further clarified. In particular, we need to discuss more whether the Fund support should or should not become a last resort support. In the absence of clear cut guidance for participants other than Fund, this could become a jump in the dark with moral hazard consequences and potentially painful financial implications.

Finally, concerning the modalities, we agree with the staff assessment that the proposal number three is the one that poses the least difficulties. At staff points out, the first and second option has the disadvantage that if the DDSR operation does not materialize, access would remain front-loaded and not be consistent with financing requirements under the program. Incorporating into the annual ESAF arrangement a special disbursement for the sole purpose of financing part of the DDSR operation, as suggested by option three, would seem a more flexible and transparent way to cope with this issue.

Mr. Yoshimura made the following statement:

I will read my prepared statement, which was drafted in consultation with my authorities, and which does not address the legal issues raised in the discussion thus far.

At the previous Board meeting (EBM/97/35, 4/9/97), my chair supported the use of ESAF resources for DDSR operations on the grounds that the Fund should be careful to ensure the concessionality of new lending to HIPCs. At the same time, my chair has called for prudent use of ESAF resources, given their scarcity; indeed, any change to existing Fund policy that might undermine current and future ESAF operations should be avoided. While the cost estimates in the staff paper show that the additional costs to the ESAF-HIPC Trust of supporting DDSR operations by ESAF-eligible countries will be relatively modest, it cannot be ruled out that countries not included in the estimates might accumulate arrears to commercial creditors and request ESAF financing for their DDSR operations. Moreover, the external debt situations of ESAF-eligible countries varies, and some of these countries should be able to afford modest use of GRA resources for their DDSR operations.

Based on these considerations, I am sympathetic to the proposal of Messrs. Bernes and Chelsky to limit the use of ESAF resources for DDSR operations to those countries qualifying for the HIPC Initiative. This proposal seems to be a good compromise, balancing the need to maintain prudent use of ESAF resources and the need to address the most serious aspects of the external debt problems of HIPCs. Furthermore, I believe that the grant element of ESAF for DDSR operations should be counted as a contribution by the Fund to the HIPC Initiative, and that it should constitute part of the Fund's interim support. The third option or modality for the use of ESAF resources for DDSR operations is appropriate. Finally, the disbursement under the third option should not take place if the program is off track at the intended disbursement point.

Mr. Newman made the following statement:

At this stage of our discussion, I will refrain from reading my statement. We can support the staff proposals. We do not believe that the additional cost to the ESAF of this proposal is very significant. It amounts to less than 3 percent of the total interest subsidy cost of the interim ESAF and HIPC, and therefore does not fundamentally alter the difficult decisions that we will need to make in the future regarding the financing of these two initiatives. Similarly, we do not believe the savings from the Canadian proposal, which is less than 1 percent of the total subsidy cost, warrants discriminating between HIPC and non-HIPC ESAF countries.

Second, we agree with Mr. Autheman that such DDSR operations will provide a means of providing interim financing for HIPC countries, but we do not see why such interim financing should only be provided to those HIPC countries that are engaging in DDSR operations, and we continue to believe that such interim financing should be provided to all HIPC countries

Thirdly, we can agree with the staff's proposals on the modality of the DDSR operation, in particular option three, although that option may be problematical at this stage since some of the ESAF creditors are still opposed.

Fourth, I was struck by Mr. Autheman's suggestion that we might simply handle this issue through the operation of the ESAF access policies. I recognize that staff could achieve the same ends by simply increasing access for individual countries based on balance of payments financing needs which included DDSR operations. I much prefer, however, the more transparent approach followed by the staff where they seek Board guidance on an issue. While it may be not the most efficient way to proceed, it certainly is preferable to having the staff go off and do these things on their own.

Mr. Donecker remarked that the Board discussion, including the statements by Mr. Bernes and Mr. Shaalan, had confirmed his earlier impression that it would have been preferable—given the monetary character of the Fund—if the current staff proposal had not been submitted to the Board. His comment was not meant by way of criticism of the quality of the staff's work in a complex and difficult area, requiring cooperation with the World Bank, but simply by way of expressing disagreement with the substance of the staff paper.

Mr. Bernes had already pointed out a number of serious flaws and risks inherent in the staff's proposal, and he fully shared his concerns, Mr. Donecker noted. Nonetheless, he had additional concerns to Mr. Bernes's regarding the wisdom of the staff's proposal, and he thus opposed the use of any ESAF resources for commercial DDSR operations per se.

His most important concern was that the Fund had to keep in mind the scarcity of ESAF resources, which had intended to be used to support active structural and macroeconomic adjustment policies in ESAF-eligible countries, Mr. Donecker indicated. The Fund, as the trustee of the ESAF, had to respect the intentions of the contributors to the ESAF. The Fund had already deviated somewhat from the original objectives of the ESAF, by allowing for the potential use of substantial ESAF resources for the HIPC Initiative, which would certainly strain the ESAF-HIPC Trust. The Fund also needed to keep in mind that, with the HIPC Initiative, it had already created a framework aimed at assisting all highly-indebted poor countries, qualifying for assistance under the Initiative, to regain sustainable debt positions. Yet, the staff was proposing that ESAF resources also be made available for commercial DDSR operations. He doubted that such use of ESAF resources would conform with the original objectives of the facility; moreover, it could, and would likely, be interpreted by many observers as a bailout of commercial creditors with highly concessional multilateral resources.

He was highly concerned about the moral hazard of using ESAF resources for DDSR operations, Mr. Donecker emphasized. Mr. Bernes, for one, had questioned whether a decision by the Fund to provide ESAF resources for DDSR operations would not automatically trigger a rise in the market value of such commercial debts, and thus make the DDSR operations more costly. He also wondered whether the staff's proposal would encourage reluctance by other donors, particularly the World Bank, to provide concessional resources for DDSR operations without accompanying concessional Fund resources. Furthermore, it was questionable whether the Board would in fact be able to limit ESAF financing for DDSR operations to the five cases mentioned in Table 1 of the staff paper. The Fund risked being drawn into combined ESAF and DDSR operations simply by virtue of the fact that a particular debtor had been able to reach a restructuring agreement with its bank creditors, which depended on substantial DDSR assistance from the Fund and Bank. Yet the economic conditions and policies of the debtor might not meet the minimum requirements of ESAF conditionality.

It was questionable why the Fund should take on additional responsibilities in DDSR operations in which it had already shown sufficient flexibility in implementing the Brady Initiative, and which were far more the domain of the Bank and IDA than of the Fund, Mr. Donecker stated. The Fund should not overlook the fact that the IDRF already provided grants for DDSR operations. He wondered about the extent to which insufficient market discounts of commercial debt for some countries—which had prevented them from qualifying for IDRF grants—had led to the demand for Fund financing of DDSR operations. If that were largely the case, ESAF financing would effectively undermine the eligibility criteria of IDA, which would be unacceptable. Even if the latter were not the case, he wondered how the Fund could limit access to ESAF resources for commercial DDSR operations to a few deserving cases without contravening the principle of evenhanded treatment of all Fund members. He would welcome the staff's comment on that point. In any event, as Mr. Bernes had pointed out, it was up to the Board of the World Bank to decide which kinds of commercial DDSR operation it wished to support with Bank and IDA resources.

The Board should not allow the Fund to be pressured to assume a greater financial burden in DDSR operations than it had already assumed, Mr. Donecker continued. If the resources of IDRF proved insufficient to finance deserving cases, it should be up to the Board of the Bank to decide on whether or not to augment IDRF resources substantially and/or to provide additional IDA credits. As indicated in the annex to the staff paper, the Fund had already helped a number of members considerably by financing commercial DDSR operations with GRA resources. He failed to see why GRA resources were too costly for some debtor members, particularly as the Fund's regular charges already entailed a considerable concessional element, and as that every commercial DDSR operation financed by GRA resources entailed substantial financial benefits to the debtor concerned, which far outweighed the interest rate cost of the GRA resources. He wondered if the real issue at stake was the somewhat stricter conditionality associated with GRA resources than with ESAF resources.

In principle, his chair opposed the creation of another facility or special lending window, which would provide ESAF resources for commercial DDSR operations, Mr. Donecker remarked. As Mr. Esdar had pointed out at the previous discussion (EBM/97/35, 4/9/97), the needs of countries potentially requiring commercial DDSR operations were covered by existing policies with GRA resources. Given the size of debt reduction achieved under those policies, it should be feasible for the remaining few heavily indebted countries (shown in Table 1) to use GRA resources with their somewhat higher charges. For concessional debt-reduction operations, the IDRF had proven to be both appropriate and sufficient. Given all of those considerations, he did not support the staff's current proposal to modify existing policies under the ESAF.

Ms. van Geest made the following statement:

> Our view on this topic is guided by two considerations. On the one hand, I would like to preserve scarce ESAF resources. I share the concern of the authors of the various Grays regarding the uncertainty of the financing of the Interim ESAF and the HIPC Initiative. In light of Mr. Boorman's remarks earlier, I must say that we do hope that the upcoming costing paper will shed some further light on this topic.
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> On the other hand, we would like to avoid the use of GRA resources by ESAF eligible countries for DDSR purposes. Use of GRA resources would run counter to our strategies to prevent heavy indebtedness and to avoid arrears to the Fund. Yes, GRA resources carry a lower interest rate than the financial markets would charge. However, for normal Balance of Payments credits we do not consider GRA-terms sufficiently concessional. I do not see why this would be different here. Also in the case of the Balance of Payments, there is a package, with donor contributions and World Bank loans. Use of GRA resources would also be at odds with my authorities' more general hesitation to use these resources as a principle for ESAF operations.
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> In the end, if push comes to shove and no alternative concessional resources prove to be available, then I could go along with the use of ESAF resources for DDSR operations as proposed by the staff. I must admit that the

statement of the World Bank representative on this topic and the latest skirmishes around Vietnam do not sound reassuring. As Mr. Autheman, I think that the Fund should only participate if really necessary, as a lender of last resort as it were.

In view of the arguments I cited earlier, it would not make sense to limit eligibility to HIPC qualifiers only. My authorities are willing to accept the consequence that these operations can then not be used as a down payment on the Fund's contribution to the HIPC Initiative.

I welcome staff's elaboration of the modalities. Not surprisingly, I have a preference for option 3, as this avoids the necessity of front-loading. It also provides the best assurance that the program is at least on track when the DDSR disbursement takes place. However, the staff proposal cannot completely tackle the problem that the ESAF Instrument does not allow for early repurchases. This remains a point of concern, as it does not only affect the way the Fund operates in the area of DDSR operations (we still cannot require a member to make an early repurchase if the program goes off track soon after the disbursement, as is the case under the GRA window), but also on other occasions, most notably in the case of misreporting. However, staff explains that the existing loans from ESAF creditors do not allow for this option and perhaps we will have to live with that. Obviously, this issue is something to keep in mind, especially when the Fund negotiates the next round of ESAF loans for the interim ESAF.

Finally, as Mr. Newman indicated, if opposition of ESAF creditors would preclude the change to the ESAF instrument as required under option 3, we may have to reconsider.

Mr. Guzmán-Calafell made the following statement:

As I explained during our previous discussion of this issue, this chair supports the use of ESAF resources for commercial debt and debt service reduction operations. We agree with the staff that this proposal implies a modest and convenient extension of the Fund's involvement in the financing of such operations since 1989. While the current policies allow ESAF-eligible countries to use GRA resources for this purpose, this would be inconsistent with the concessionality required in all the new borrowing by these members. The fact that so far GRA resources have never been used by ESAF-eligible countries for the financing of debt and debt service reduction operations is indicative in this regard. I also note that ESAF resources would be expected to be the least concessional component of financing packages structured for this objective. It is very important to stress that these operations need to be guided, as noted by the staff, by the same general principles of the existing policy concerning conditionality, burden sharing, efficient use of Fund resources, and market-based operations. This implies, among other things, that Fund support for these operations has to be linked to strong medium-term adjustment programs.

The concerns expressed by a number of chairs with respect to the implementation of this policy in the context of the limited resources available to the ESAF are understandable. However, the amounts involved are relatively modest. On an "as needed" basis, the staff estimates the potential interest subsidies needed to support the 5 cases considered in the paper in a range of 41 to 75 million SDR's. This compares with requirements of 2.5 billion SDR's in interest subsidies on an "as needed" basis for the interim ESAF and the HIPC Initiative. Furthermore, while these estimates are subject to wide margins of error, they may overestimate the actual figures. In this respect, it is worth noting that in page 8 of the paper the staff note that in the case of Cameroon, Congo, Tanzania, and Zaïre "while it may be possible to reach agreements on straight buy backs or their equivalent, the possibility that these members and their creditors would reach agreement on a Brady-style DDSR operation cannot be precluded." This seems to imply that while the staff does not rule out the possibility of Brady-style operations for these countries, the expectation is that ESAF resources for this purpose will not be actually needed in all or most cases. At the very least, with the staff's comment in mind I find it difficult to expect that Cameroon, Congo, Tanzania and Zaïre will all be requesting the use of ESAF resources for DDSR operations. I would like to hear the staff's views on this.

On the options put forward by the staff to incorporate DDSR operations into ESAF arrangements, there is little doubt that the best option would be to include into the annual ESAF arrangements a special disbursement for the sole purpose of financing the corresponding portion of the DDSR operation, if this takes place. With respect to the proposal that the Fund should claim credit under the HIPC Initiative for this use of ESAF resources, I fully agree with Mr. Shaalan that given its implications for eligibility this would go against the principle of evenhandedness. It must also be taken into account that cost-savings resulting from the support with ESAF resources of DDSR operations only in the case of countries under the HIPC Initiative would not be very large since, as Mr. Boorman has explained, several of the members which the staff deem as potential candidates for such support may also be eligible for participation in the HIPC Initiative. I am also concerned by the legal implications of restricting access to ESAF resources for DDSR operations only to HIPC countries. For these reasons, I can go along with the staff proposal that the Fund should not seek to claim credit under the HIPC Initiative for this use of ESAF resources.

Finally, on the issue of Vietnam, I agree with the staff that this operation should proceed as envisaged originally, since there are no valid reasons to substitute more concessional resources with relatively more expensive ones.

Mr. Zoccali made the following statement:

Staff has raised the possibility of using ESAF resources for the few remaining cases in which commercial debt and debt service reduction (DDSR) operations may be relevant. We remain convinced that in those cases where the test of efficiency is incontrovertibly met, channeling ESAF resources for this purpose along the lines recommended by staff is both consistent with the ESAF Trust Instrument and the most"even-handed" extension of the Fund's policies in support of such operations in general.

I would, therefore, fully associate myself with the first three comments of Mr. Newman. Regarding the level of access to ESAF resources, I would tend to agree with Mr. Autheman that flexibility as a function of need and the quality and strength of the program would best serve to further its purposes.

It should be stressed, however, that given the concessionality and relative scarcity of ESAF resources, their use in support of market-based debt reduction operations should be subject to appropriate burden-sharing with IDA, other donors and financing from the member's own resources. Moreover, access to ESAF resources for DDSR operations should be viewed as a last resort contribution to facilitate implementation of this crucial element for the restoration of external viability in the countries concerned.

Mr. Bernes and Mr. Chelsky in their statement have highlighted the relative scarcity of ESAF resources. Their approach to exceptionally limit access to ESAF resources for DDSR operations only to members which qualify for assistance under the HIPC Initiative, serves to focus attention on the increasing distortions stemming from the prevailing lack of political will to close the needed funding, which if allowed to persist could end up undermining the effectiveness of ESAF as the centerpiece of the strategy for dealing with the problems of reforming low-income countries.

This chair sympathizes with the objective of maximizing the benefits of the Fund's involvement in low-income countries as would reasonably be expected not only of HIPC eligible countries but of other ESAF eligible members meeting a single standard of conditionality in the context of strong programs of adjustment and reform. We also recognize also the importance of clarifying the burden sharing issue to the extent possible in order to minimize the risk that Fund support could displace other concessional financing or result in an increase in the secondary-market price of outstanding commercial debt. These calculated risks notwithstanding, we conclude that potential use of ESAF resources for DDSR operations would not alter significantly the overall resource requirements for achieving a self-sustained ESAF and could on balance contribute to generating a more conducive environment for investment and growth in the low-income eligible cases for which is envisaged.

Regarding the options mentioned by staff to deal with the situation in which DDSR operation does not take place, we consider that staff's third option, in paragraph 16 of the paper, would pose the least difficulties and best serve to preclude the prospect that availability of concessional ESAF resources be perceived as a commercial bank "bail-out."

On whether the Fund should seek to claim credit for the illustrative SDR 30–52 million interest subsidy implicit in the use of ESAF resources for DDSR operations when calculating its contribution to the HIPC Initiative, staff's recommendation comes closest to ensuring uniformity of treatment in the application of this important element for securing external viability.

Finally, rather than continuing to focus on the potential "bail out" prospects for commercial banks and to different approaches to deal with the issue, including the creation of a new facility, which would also not entirely dispel the concerns raised, the Board's judgment must instead serve to urge early implementation of the existing understandings on ESAF/HIPC financing, including gold sales. In this regard, we should endeavor to keep uppermost in our minds the costs of delaying implementation of commercial debt resolution agreements in terms of foregone opportunities for investment and growth in the debtor countries that are making a serious effort to implement sound policies. In this same vein, the envisaged revised costing paper of the initiative should not only shed light on the likely increase in costs associated with the change in the eligibility list but, as importantly, the opportunity cost for the Fund from the delay in the transfer of SCA-2 resources and postponement of gold sales and investment of profits, thereby limiting the availability of total resources for the initiative which we have all supported.

Mr. Kiekens made the following statement:

What we are considering is how to solve the problem of countries that cannot finalize a debt reduction or debt restructuring arrangement with their commercial creditors because they lack—or at least are considered to lack—sufficient owned resources and concessional borrowing capacity to satisfy their side of the agreement in terms of up-front and early repayment of part of the debt and providing collateral for the remainder.

There are two possible solutions to such deadlocks: either the commercial creditors accept arrangements that are more favorable to the debtor countries, or we provide public subsidies in order to make the arrangements possible. Today we are exploring the latter avenue.

Subsidizing debt reduction operations between commercial banks and sovereign debtors obviously creates a serious moral hazard. Commercial creditors, during debt rescheduling and debt reduction negotiations, will not accept more concessions than are strictly necessary to reach agreement with debtor countries, taking into account the amount of available subsidies. The more subsidies we provide, the smaller will be the concessions the commercial creditors will have to accept.

Should we conclude from this that we should categorically refuse ESAF financing for commercial debt and debt service restructuring (DDSR) operations? I do not think that categorical refusal would be, in present circumstances, the right answer. With the HIPC Initiative, and during the negotiations between Cote d'Ivoire and the London Club, we have created expectations on the part of the commercial banks that ESAF financing would become available. Reversing those expectations would be very difficult. A negative decision today could lead to protracted negotiations between commercial banks and sovereign debtors that will involve considerable costs in terms of foregone investment and growth for the countries concerned. I thus favor a positive decision, along the lines proposed by the staff, provided that we take the necessary precautions to strictly limit both the cost of this initiative to the ESAF Trust, and thus the extent of the moral hazard on the side of the commercial creditors.

At our last Board discussion on commercial DDSR operations, I outlined three specific conditions for accepting ESAF financing for such operations:

These operations should not compromise the implementation of the HIPC Initiative nor of the continuation of normal ESAF operations.

They should be confined to deep discount DDSR Brady-style operations for which sufficient concessional non-Fund financing has not been available.

They would be subject to appropriate conditionality and thus take place in the framework of an ESAF program.

I was also concerned that the secondary market discounts would be reduced as soon as the availability of ESAF financing was decided, and that IDA might be tempted to shift part of its financing burden for these operations to the ESAF Trust. The emerging disagreement between the World Bank and the Fund on the concessional financing of the DDSR operation with Vietnam proves that my concern was not unfounded.

The staff has provided us with reasonable assurances concerning these conditions.

First, the staff estimates that the total subsidy cost, on an as needed basis, will be limited to SDR 41 to 76 million for the five countries that are likely to benefit from this special type of ESAF financing. This represents a maximum of 3 percent of the total budget for the continued ESAF and HIPC operations, and is less than the error margin of the estimated costs of the continued ESAF and HIPC operations.

Second, the staff has appropriately limited the scope and conditions of the ESAF Trust's involvement. I see no need for ESAF's subsidy support for DDSR operations to extend beyond Brady-style operations.

Third, since the financing of DDSR operations will take place in the framework of an ESAF program, we have assurance that our financial support will catalyze the necessary policy adjustments. It is needless to repeat here the critical importance of appropriate conditionality, which is much more important than the subsidy component of our financing.

Arguably, the staff cannot provide firm indications on how secondary market discounts would behave following the announcement of the availability of ESAF participation for a given DDSR operation. This does not mean that there is no moral hazard problem, as I noted at the outset of my intervention. The most effective way to limit this moral hazard is to be strict on the limitations we will set today and to have a clear understanding with the World Bank on how to distribute the financing burden between IDA and the ESAF Trust. Somewhat to my surprise, we learned today from the World Bank representative that IDA has no clear policy rules for its financing of DDSR operations, but decides its interventions on a case-by-case basis. Many Directors insisted, during our last meeting and today, that ESAF's financing should be strictly subsidiary to IDA financing, and sought only as a last resort. However, in the absence of clear IDA policy rules, I fear that if ESAF accepts to finance the balance on a subsidiary basis, it will find itself subordinated to the policy decisions taken by the World Bank or IDA. I therefore repeat my call for a clear prior understanding with the World Bank, which should agree to establish its own policy in order to enable the ESAF Trust to limit the cost of its interventions to the levels contemplated in today's staff paper.

I can agree that the Fund should not claim credit for the use of ESAF resources for DDSR operations when calculating its calculation to an HIPC operation.

On the modalities of the Fund's involvement, I agree to incorporate in the annual ESAF arrangement a special window exclusive for financing a part of the DDSR operations if and when such operations materialize.

Mr. Taylor remarked that, before the discussion, he had been inclined to support the staff's proposal, particularly as it would not imply a large burden on ESAF resources, as Mr. Newman had noted. However, given that several important concerns had arisen in the current discussion, he wished to have more time to consider the legal ramifications of the alternative proposal by Messrs. Bernes and Chelsky paper. Like Mr. Kiekens, he also wished to receive assurances on IDA policy in burden-sharing of DDSR operations. Several Directors, moreover, had noted the possibility that the staff's proposal, appearing to suggest that the Fund spend money that it did not yet have, might unsettle ESAF trustees. As Mr. Zoccali had indicated, the real problem was the ongoing—perhaps growing—uncertainty about the financing of the ESAF-HIPC Trust. In view of the foregoing, he wished to reserve his final position until the Board's subsequent discussion, as proposed by the Acting Chairman.

Mr. Shields commented that his chair had originally been reasonably attracted by the proposal of Messrs. Bernes and Chelsky as a means of limiting the use of scarce ESAF resources. The statement by the Legal Department had appeared to have effectively quashed that proposal, although it would be premature to conclude that the intentions of that proposal could not be realized by other means. Like Mr. Taylor, he preferred to reserve his final position until the subsequent discussion.

For the ESAF countries eligible for the HIPC Initiative, Mr. Autheman had referred to providing interim relief in the form of expanded access under the ESAF for commercial DDSR operations, Mr. Shields noted. While that might be appropriate for Côte d'Ivoire, there might be other countries that could receive alternative forms of interim relief under the HIPC Initiative.

In principle, the Fund should claim credit for any DDSR operations under the HIPC Initiative, Mr. Shields remarked. If the Board were to approve the staff's proposal, moreover, he would favor the third option for providing ESAF resources for DDSR operations. That being said, he agreed with Ms. van Geest that the Fund should also consider modalities allowing for early repayment of ESAF resources.

Mr. Al-Tuwaijri made the following statement:

> The staff report goes a long way to specify the financial and operational implications of using ESAF resources for commercial DDSR. The conclusions confirm the concerns that I shared with a number of other Directors in the April discussion of this proposal. Here, let me reiterate the key issues.
>
> The resource constraint has to be fully recognized. We are still far from an adequate funding of either ESAF or the HIPC Initiative. Indeed, the prospects in that regard have to be evaluated in the context of prevailing fiscal stringencies and the current state of debate on key issues. On the proposal's likely cost, the staff recognizes that their estimates are illustrative and necessarily subject to wide margins of error. Also, the commitment is open-ended with access for all ESAF eligible countries. In the circumstances, one simple way to constrain ESAF resource use for commercial DDSR operations may be to set a specific limit on the amount available for the purpose. I will appreciate staff comments.
>
> Like other Directors, I remain unclear on the burden-sharing issues between the Fund and other multilateral creditors. From Paragraph 7 of the staff report, it appears that the Fund's role comes at the tail end in cases in which the up-front cost of operations would exceed the resources available from all other sources. In that event, the burden-sharing issue arises as an extraordinary issue and not as a regular feature of all commercial DDSR operations. There is need for clarity on this matter.
>
> Regarding the proposed modalities, I believe we should take the most transparent approach. I therefore favor the staff's proposed third option for inclusion of the amount into annual ESAF arrangements for disbursement to take place only if the DDSR operation actually materializes. I also agree with the staff that it may be preferable to retain access for all ESAF-eligible members.

Mrs. Guti made the following statement:

> At the previous meeting, we indicated our broad support for the proposal put forward for consideration but, like a number of other Directors, expressed our concern about the additional demand that its adoption would place on ESAF resources, especially in light of the substantial shortfall in the contributions to the ESAF Trust Fund. We also wanted to learn a bit more about the status of the credit facility that is being considered by the World Bank to supplement the IDA debt reduction facility. While we still have some concerns in these areas, we believe that the tentative estimates produced by staff, of the probable resource requirements for these commercial debt and debt

service operations seem to be relatively modest and could perhaps be accommodated by ESAF resources. We can therefore, support the proposed use of ESAF resources for these purposes under the circumstances specified. However, we would hope that the Fund would soon explore the option of sale of gold in order to maximize resources available to support ESAF. We also agree with the issue raised by Mr. Mirakhor earlier, regarding the opportunity cost of delaying this issue.

On the modalities for the use of ESAF for DDSR, we can agree on option three which seems to present the least difficulty in operational terms.

On the question of whether or not the Fund should claim credit under the HIPC initiative for the use of ESAF resources for commercial DDSR, we have carefully listened to the discussion this morning. While we feel that we could also benefit from the further elaboration requested by other Directors from the staff, we can go along with the staff proposal for the Fund not the claim credit under the HIPC Initiative.

Mr. Vernikov made the following statement:

The arguments and calculations presented in the staff paper provide additional support to my position in favor of using ESAF resources for commercial debt restructuring. Although I share other Directors' concerns about the availability of financing for ESAF/HIPC, the amounts projected by the staff seem rather modest.

As for the modalities for the use of ESAF resources for DDSR operations, I agree with the staff's third option, which appears to be the least cumbersome.

Like the staff and like Mr. Shaalan in his "Gray," I also think that there is no need to tie the use of ESAF resources in commercial debt restructuring directly to the HIPC Initiative. At the same time, I see no need for the establishment of a special new facility. I would rather rely on the existing instrument.

I agree with Mr. Autheman that we should not a priori exclude any ESAF eligible country from the list of potential beneficiaries.

To sum up, I endorse the staff's proposals.

Mr. O'Brien stated that he supported the staff's proposal. Two main issues were at stake. First, there was the question or principle of the evenhandedness of treatment of member countries, which had been well addressed in the discussion thus far, and which the staff's proposal did not violate. Second, there was major concern about the availability of ESAF resources, and about whether use of those resources for commercial DDSR operations would undermine the ESAF-HIPC Trust, including contributions by donors. Given that he agreed with Mr. Newman that the potential costs of the staff's proposal appeared to be modest, and should not unduly impede the financial integrity of the ESAF-HIPC Trust, he could support the staff's proposal.

He did not believe that access should be limited to the countries that qualified for the HIPC Initiative, Mr. O'Brien said. In line with the principle of evenhanded treatment, ESAF-eligible countries that could not finance fully the up-front costs of DDSR operations without Fund support should be able to use ESAF resources to that end—and need not be only those that qualified for the HIPC Initiative. Moreover, the staff paper had noted that ESAF resources would be used for DDSR operations in tandem with an ESAF arrangement, which should assure adequate conditionality and thus a strong program in support of the DDSR operations. He was thus assured that ESAF resources would be used in a manner consistent with the ESAF Trust Instrument.

The Fund should not claim credit under for the HIPC Initiative for use of ESAF resources for DDSR operation, Mr. O'Brien considered. As the staff had noted, in only a few cases could that claim be made, and, if it were made, would unduly limit the number of countries that could use ESAF resources for DDSR operations.

He supported the third option for providing ESAF resources for DDSR operations, which provided for greater transparency and a better means of monitoring and targeting the application of ESAF resources, Mr. O'Brien remarked.

The issue of burden-sharing needed to be clarified and the Board needed to be reassured of Bank policies in that regard, specifically regarding the use of ESAF resources, Mr. O'Brien added.

The Executive Board recessed at 1:00 p.m. and reconvened at 2:30 p.m.

Mr. Rouai made the following statement:

> We had wished to see a conclusion to this subject today, but reluctantly agree to a postponement of the final decision to next week, provided there will be no further delays. We are also concerned with the considerable delays and uncertainties surrounding the financing of the HIPC Initiative as well as the interim and self-sustained ESAF. Consequently, it may well be that the added cost of the ESAF-HIPC Initiative exceeds the actual Fund's contribution under DDSR operations.
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> On the operational modalities for DDSR operations, we associate ourselves with Mr. Shaalan's statement, specifically:
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> From options dealing with the situation where an anticipated DDSR operation does not take place, we favor incorporating into the annual ESAF arrangement a special disbursement for the sole purpose of financing part of the DDSR operation upon completion.
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> We believe that Fund assistance under the DDSR operations to low-income countries should be available regardless of member's qualification for the HIPC Initiative.
>
> We agree that the Fund should not seek credit for its assistance in DDSR operations under the HIPC Initiative.

Mr. Barro Chambrier made the following statement:

This chair strongly supports the use of ESAF resources for Commercial Debt and Debt Service Reduction operation for low income countries for the reason that the additional costs are relatively modest and it would not significantly affect the resources requirement of current and interim ESAF. At the same time we agree that it is important to continue our efforts to secure the needed resources.

On the proposed modalities for use of ESAF resources for DDSR, I support option 3 for the same reasons as clearly stressed in the staff paper. Like previous speakers, I agree that we should adopt a case by case approach in a flexible manner in order to allow some ESAF countries to benefit from the use of ESAF resources in their effort to normalize their relations with creditors and attain sustainable debt positions.

Mr. Joyosumarto made the following statement:

In the previous discussion on this issue, this Chair has expressed reservations on the this proposal due to the unresolved funding for the interim ESAF and the HIPC Initiative. This reservation remains and I would like to urge for an early discussion of the revised estimates of the costs for the interim ESAF and the HIPC Initiative and the status of bilateral contributions thus far. The discussion this morning has also increased our reservations. In addition to the legal note that will be provided, we would also be interested to have in writing the clarifications provided by Mr. Boorman to the various queries raised this morning. They would be of considerable interest to the ESAF contributors in my constituency. For the continued discussion on this issue next week, we would like the staff to include details of IDA operations with respect to these DDSR operations, as well as clarifications from the World Bank as to what they mean by equal burden-sharing.

However, notwithstanding these reservations, this chair can support in principle the proposed use of ESAF resources for DDSR operations. As Mr. Newman and others have pointed out, the amount involved is relatively small, and such operations would further contribute to the restructuring efforts of ESAF countries.

On the manner in which such operations can take place during an ESAF arrangement, we would prefer option three, as it would provide the greatest flexibility and transparency.

On the question of whether the Fund should seek to claim credit under the HIPC Initiative for this use of resources, we tend to support the staff recommendation that it should not be counted as part of the Fund's contribution to the HIPC Initiative. This proposed extension of the use of ESAF resources should be of benefit to all ESAF-eligible member countries.

Finally, on the issue of Vietnam, it is now clear that the amount and availability of DDSR financing from IDA resources is not yet certain. Based on the principle of equal treatment, we would thus strongly urge for the inclusion of Vietnam in both the Bank and Fund DDSR operations.

Thank you.

Ms. Srejber made the following statement:

As we will have to digest the new information we have been provided with today, I will wait to express my final view until next week. Let me, however, make some remarks today.

Mr. Bernes has done an interesting analysis of the different aspects of this undertaking pointing to many problematic issues with staff's proposal. This issue is quite complicated and, as this chair has already said earlier, there are many pros and cons and still many questions that have not been fully answered, where more information by the staff would be warranted, for example, the relationship with the IDA Debt Reduction Facility, the new IDA policy for these countries, burden sharing and, as today's discussion has shown, the legal issues. I join Mr. Joyosumarto in his request for clarifying notes in the legal issue, Mr. Boorman's explanations, details of IDA-operations and World Bank views on burden sharing.

I agree that we have to fully recognize the principle of uniform treatment of Fund members. Of course, one can argue that limiting this proposal in its present design to the HIPC-countries could be viewed as contrasting with the principle of evenhandedness as pointed out by Mr. Shaalan and the Legal Department. But Mr. Bernes has shown another angle of this dilemma as he points out in his statement that extending eligibility for ESAF resources for DDSR operations to all ESAF-borrowers raises the issue of how to treat countries that have earlier used GRA resources for their DDSR operations. On balance, this chair, however, strongly prefers not to limit the proposal to HIPC countries only, as this would leave a few countries without suitable debt relief and thus imply nonuniform treatment.

I am, however, skeptical to the staff's proposal at a time when sufficient funding of ESAF and HIPC has not been secured. I would like the staff to present more precise cost estimates as soon as possible, and to inform the Board about any major developments affecting those estimates.

Mr. Donecker said that he wished to assure the Board that his lack of support for the staff's current proposal did not mean that his chair was opposed to participating actively in a search for a better solution, which took into account the major concerns voiced by several Directors, including Messrs. Bernes and Chelsky.

Mr. Chelsky commented that a troubling aspect of the overall question of the use of ESAF resources for commercial DDSR operations was the World Bank's change of position on Vietnam. The Bank had previously been prepared to provide IDA resources for Vietnam's DDSR operation without ESAF support to that end. Perhaps the change in position had resulted from the Bank's expectation that ESAF resources would become available for DDSR operations, in contrast to the previous situation, when they had not been available. As the

Director of the Policy Development and Review Department had indicated, the Fund was reluctant to agree to the request by the management of the Bank for ESAF support for Vietnam, which would effectively substitute less concessional ESAF resources for more concessional IDA resources, to the detriment of Vietnam. He thus welcomed the fact that the Board had called for clarification from the Bank on its policy on burden sharing. For the Bank to clarify that policy, it would have to consider the matter in its Board—which, indeed, should address that policy issue. That being said, he tended to agree with the view that were was in fact no formal burden-sharing policy for DDSR operations. The fact that the Bank had undertaken Structural Adjustment Loans and balance of payments assistance without any formal burden sharing with the Fund suggested that IDA could finance DDSR operations adequately without Fund support. To the extent that the availability of ESAF resources for such operations encouraged the management of the Bank and IDA to require ESAF resources, the Fund was effectively substituting in place of IDA resources, [with a grant element of 80 percent], ESAF resources with a significantly lower grant element. That substitution would be to the significant detriment of the debtor countries that could access IDA support for DDSR operations.

The Director of the Policy Development and Review Department commented that it would be for the Bank to comment on its policies on burden sharing. In the final analysis, what was at stake was whether or not IDA credit resources, which the management of the Bank might be willing to set aside for DDSR operations, would be sufficient to finance the up-front costs of DDSR operations, or whether larger up-front costs of DDSR operations meant that Bank genuinely needed to seek other resources, including from the Fund, to support those operations. While it was unquestionable that IDA resources were more concessional than ESAF resources, and that one would prefer to use only IDA grants, IDA resources were in fact limited.

Contrary to the statement of Messrs. Bernes and Chelsky, no countries had financed their debt buybacks through the IDRF and had simultaneously used GRA resources, the Director pointed out; hence, no countries could, or would conceivably seek under the staff's proposal, to refinance their DDSR operations with ESAF resources.

In general, the Fund was not targeting countries for eligibility for ESAF resources for DDSR operations, the Director said. The staff's reference to specific countries in its paper had simply been an attempt to bring to the attention of the Board the best available information on the countries that might engage in Brady-style DDSR operations that could warrant support by ESAF resources. At present, the four countries listed in Table 1—Cameroon, Congo, Tanzania, and the Democratic Republic of the Congo, formerly Zaïre—were the only ones that the staff believed might not be able to agree on straightforward buybacks of their commercial debt, financible by the IDRF. In fact, discussions had not yet begun for the Democratic Republic of the Congo, and were still at an early stage for Cameroon and Congo. It would still be premature for the staff to prejudge the likely structure of the debt renegotiation to be agreed in those discussions. In the case of Tanzania, negotiations were well advanced on a straight buyback financed by the IDRF—though it was possible that the likely agreement could broaden into a menu of options. For that reason, the staff had included Tanzania in its cautious estimates.

Regarding the question of whether or not the provision of ESAF resources for commercial DDSR operations would represent a bailout of commercial banks, the Fund had helped finance the up-front costs of many countries' DDSR operations for the previous eight years (since 1989), the Director recalled. Such financing had helped those countries to normalize their relations with creditors and to regain access to international capital markets. It was recognized that multilateral support for DDSR operations could affect the secondary market prices of the countries' debt. Nonetheless, in submitting countries' requests for support for DDSR operations to the Board, the staff had informed Executive Directors of the relevant history of the countries' debt in secondary markets, particularly at critical moments, such as before the start of debt negotiations, at the start of negotiations, and when information had become available about the intentions of multilateral institutions in regard to the DDSR operations. In each of those cases, the Board had approved Fund support for the operations, on the grounds that the impact of Fund support on the secondary market price of the debt would not be so substantial as to make the support too costly.

Fundamentally, the policies of countries and the resulting economic adjustment—as seen by market participants—were the key to restoring normal relations with creditors and re-opening access to international capital markets, the Director stated. In that sense, Fund financing of the up-front costs of DDSR operations was secondary to the fundamental purposes of the accompanying ESAF arrangements, or in the case of GRA resources, the Stand-By or Extended Arrangements. In proposing use of ESAF resources—as opposed to GRA resources—to help finance DDSR operations in a few low-income countries, the staff had no intention of weakening conditionality. Rather, the intention was for countries to have the policies in place that were necessary to restore their access to capital markets or commercial bank financing, if appropriate.

In the past, there had been no hard rules on burden sharing in DDSR operations, the Director noted. Nonetheless, the Bretton Wood institutions, other institutions, and bilateral contributors had participated in many such operations on a case-by-case basis. In those operations, the Fund's contribution had typically been in the order of 25–33 percent of total up-front costs, but only after it and the Bank had made every effort to raise resources from bilateral creditors and from the countries themselves. In many cases, the countries that would engage in the DDSR operations had contributed significantly. The percentage contributed by the Fund had been a residual, not a percentage set before the DDSR operations according to rigid rules of burden sharing. Given the small number of countries that would potentially need ESAF financing for their DDSR operations, each of which would need to be assessed individually, it would be counterproductive to try to devise rules on burden sharing. That being said, the staff would take into account, in every case, the Board's wish that Fund support should be subsidiary, or a last resort, and that the Fund should not overtake the Bank's role in DDSR operations via IDA in low-income countries.

The use of the third option for providing ESAF resources for DDSR operations would not require the consent of creditors to the ESAF Trust, but simply a majority vote of the Board, the Director clarified. For that purpose, the staff would present a draft decision to the Board, if the latter were to approve the current staff proposal.

While it would not be possible to place formal limits on the use of ESAF resources for DDSR operations, the resource needs of countries could be dealt with under the Fund's general access policy, using all of the information available about the up-front costs of the DDSR operations of the countries concerned, including the share of costs owed to the Fund, the Director added. Irrespective of the Board's strong preference for the Fund to play a subsidiary role in burden-sharing, the ESAF resources required by countries for DDSR operations would be limited relative to the countries' quotas.

The Acting Chairman adjourned the discussion. The Board would meet again on 7/2/97 to conclude its discussion on the staff's proposal for use of ESAF resources for commercial DDSR operations.

3. PERU—1997 ARTICLE IV CONSULTATION; AND EXTENDED ARRANGEMENT—REVIEW, AND PROGRAM FOR SECOND YEAR

The Executive Directors considered the staff report for the 1997 Article IV consultation with Peru and the review under the Extended Arrangement and the program for the second year (EBS/97/102, 6/11/97). They also had before them a statistical appendix (SM/97/148, 6/11/97).

Mr. Zoccali made the following statement:

> My Peruvian authorities wish to thank management and staff for their support and advice since 1991. The main economic priorities of my authorities since 1990 have been to consolidate macroeconomic stability and to implement a wide range of structural reforms aimed at setting the basis for sustainable growth and improving the standard of living of the population. During this period, the Fund has played an important role in the effort to restore macroeconomic balance and normalize relations with external creditors. In six years, inflation declined from 7600 p.a. to the present single digit level, a protracted period of economic contraction was turned into one of strong expansion and generalized debt arrears were virtually eliminated, attesting to the effectiveness of a comprehensive strategy of adjustment and reforms and to the strong political will to follow-through with successful policy implementation.
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> Economic performance during 1996 was in line with the program objectives and all performance criteria were met with margins. Tighter financial policies contributed to the decline of inflation to 10 percent during the second half of the year. Higher international prices for petroleum and food imports, however, adversely impacted on the consumer price index, resulting in a rise to 11.8 percent for 1996 as a whole. The maintenance of a tight financial policy stance in 1997 has reinforced the downward trend of inflation. For the year ending in May, inflation declined to 8.8 percent. In addition, the pace of output growth, which had slackened to 2.8 percent in 1996 due to the initial impact of the fiscal tightening, recovered strongly during the first four months of 1997. Private investment and exports led the upswing as the policy stance boosted confidence and credibility. Domestic output grew by 7.3 percent during this period and was particularly strong in the agriculture, manufacturing and construction sectors.
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> These favorable trends, which included continued strong productivity gains, were underpinned by a strengthening of the public finances and the adoption of widespread structural reforms. The primary surplus of the public sector exceeded program projections for 1996 and reached 1.2 percent of GDP. Data for the period January–April 1997 show a further improvement as tax revenues increased 5 percent in real terms on the strength of value-added

tax collection, while real nonfinancial government expenditures declined by a similar magnitude vis-à-vis the same period last year.

The reduction in the current account deficit in 1996 of 1.5 percent of GDP is noteworthy. This resulted from lower interest payments stemming from the conclusion of debt reduction and rescheduling agreements with official and commercial creditors and a narrowing of the trade deficit in spite of an unanticipated deterioration in the terms of trade. Long-term capital inflows not only covered the current account deficit but facilitated the further accumulation of international reserves. The NIR position of the central bank, including foreign currency reserve requirements and deposits of the pension reserve fund, reached the equivalent of 15 months of imports at end-May 1997. Notwithstanding sizable capital inflows, the real exchange rate has remained relatively stable. During the first four months of this year, the trade balance has continued to improve despite the pick-up in domestic economic activity. Non-traditional exports, led by textiles, rose by 38 percent with respect to the same period of last year. Textiles have become the third largest Peruvian export after copper and fishmeal. It is also worth noting that import growth has been led by capital goods, which increased by 27 percent during the same period.

A distinguishing feature of Peru's balance of payments is the large proportion of its current account deficit financed by long-term private capital inflows, of about 70 percent in 1996 excluding privatization proceeds. Foreign direct investment (excluding privatization proceeds) amounted to some $1.9 billion or 3.2 percent of GDP. The sizable foreign direct investment demonstrates the renewed interest of investors in the context of restored credibility and confidence regarding Peru's economic prospects. Foreign direct investment, however, is having a significant temporary impact on imports and is conditioning the profile of the current account balance. In the short run, the sharp increase in imports associated with this type of capital inflow produces an unavoidable deterioration of the current account deficit. As investment projects mature, however, they are expected to generate strong and sustained export growth, contributing gradually to the reduction of the current account deficit in the medium term.

Further progress was also made in 1996 in remonetization and financial deepening. Broad money as percentage of GDP increased by 6.6 percentage points since 1993, to almost 21 percent by end-1996, while credit to the private sector grew by 9 percentage points, to close to 20 percent of GDP during the same period. Nevertheless, it has taken Peru over six years after its bout with hyperinflation to re-establish the monetization levels prevailing during the 1970s. These levels, however, are still lower than those in other countries of the region. An important element in this regard is that credit expansion now reflects increased intermediation through the formal financial system thus contributing to financial deepening and greater efficiency.

In response to the small rise in the ratio of nonperforming loans noted by the staff, associated with the temporary slowdown in economic activity in 1996, provisioning as a share of total bank credit outstanding was increased from 4.2 percent in April 1996 to 4.7 percent in April 1997. The soundness of the financial system is buttressed by an actual capital to-risk weighted asset ratio for the banking system of 9.9 percent. A high level of official international reserves, which at end-May 1997 represented seven times the monetary base, covering some eighty percent of total deposits makes evident the built-in safeguards to prevent systemic banking difficulties. Peru's flexible exchange rate arrangement and its prudent monetary and fiscal policies complete the policy framework to support macroeconomic stability.

The main objectives of Peru's economic program for 1997 are a firming of output growth to about 5 percent, reducing inflation to 8–10 percent, raising domestic savings to 19 percent of GDP, narrowing the current account deficit to less than 5.5 percent of GDP and strengthening further the net international reserves position of the central bank.

To achieve these objectives, the primary surplus of the combined public sector is being increased to 1.3 percent of GDP through strict control over noninterest current expenditures and efforts to generate larger efficiency gains in tax administration. These more than offset the projected revenue loss associated with the reduction in import tariffs. In addition, measures have also been taken by the government to enhance budgetary management and coordination among public sectors units.

Monetary policy remains geared exclusively to reducing inflation and is implemented through market-based instruments. Base money is used as the intermediate target and its adequacy is reviewed regularly on the basis of a broad set of indicators of future inflation. Under the flexible exchange rate arrangement, central bank intervention seeks only to smooth large fluctuations in the exchange rate.

To provide adequate support to financial policies, the emphasis of the current program lies in the continued implementation of broad-based structural reforms encompassing further divestitures of public enterprises operating in the fishing, energy and mining sectors. Given the detailed description in the staff report and in my authorities' letter of policy intent, I will highlight just a few aspects that deserve special attention.

First, a new Banking and Superintendency of Banks Law was enacted last December with the aim of enhancing banking supervision, tightening prudential regulations and strengthening the institutional capacity of the Superintendency. The law introduces the concept of consolidated supervision, improves the mechanisms for controlling money laundering, tightens provisioning standards, strengthens minimum capital requirements, and takes market risk explicitly into account. Under the new law the minimum risk-weighted capital/asset ratio of banks will be increased in two stages, to 8.7 percent effective July 1, 1997 and to 9.1 percent as of January 1, 2000.

Second, in April 1997 import tariffs were lowered from 15 to 12 percent for over 85 percent of total imports and from 25 to 20 for the rest. The introduction of a 5 percent surcharge on certain agricultural imports (which comprise 5 percent of tariffs categories) was conceived as a temporary and nondiscriminatory measure. This measure has been deemed consistent with WTO obligations and in no way alters my authorities' commitment to an open trading system.

Third, to foster private investment, legislation was enacted last December creating the Commission for the Promotion of Private Concessions (PROMCEPRI) with the aim of shifting to the private sector the production and distribution of electricity and the construction and operation of tourism facilities, highways, ports and airports under the modality of concessions. This law also mandates the establishment of autonomous regulatory agencies to enforce compliance of contracts and environmental standards and ensure adequate protection of consumers. On June 13, the government issued the regulations for implementation of the Land Tenure Law, aimed at promoting agricultural investment, including through the sale and/or concession of governmental lands to private investors.

Last, but not least, poverty alleviation constitutes a central priority. To this end, the government has stepped up social spending, from $12 per capita in 1990 to $158 in 1996, and improved targeting to reach the most vulnerable sectors of society. The share of the population living in poverty has declined from 54 percent in 1991 to 45 percent in 1995 and extreme poverty dropped from 22 to 19 percent during the same period. Last week, the government announced an ambitious strategy aimed at halving extreme poverty by the year 2000 through a concerted effort to improve delivery of basic social services and infrastructure.

The continued pursuit of sound and prudent financial policies, the implementation of debt reduction and rescheduling agreements with official and private creditors and the deepening of structural reforms provide grounds for optimism regarding Peru's future. The strong track record in policy implementation that my authorities have established during the past seven years enhances the prospects for attaining strong sustained growth and for adapting the country's institutions to meet both the challenges of globalization and the legitimate social demands of its population.

Mr. Toribio made the following statement:

This chair welcomes the staff papers on Peru, which clarify the evolution of the country's economy and provide a solid basis on which the Board can make a decision. I also thank Mr. Zoccali for his useful statement. As he explains, Peru is a clear example of how sustained commitment to macroeconomic stability and structural reform tends to foster economic growth, alleviate the unfortunate conditions of the poor, and increase general social progress. In fact, Peru's GDP has grown by more than 3 percent in real terms in each of the previous four years; the inflation rate has declined from more than 7,000 percent to tolerable one-digit levels; and foreign currency reserves of the central bank have more than quadrupled. All available welfare indicators show moderate, but continued, social progress in terms, inter alia, of literacy, life expectancy, per capita income, and personal savings. Though the data for 1995 indicates some deterioration in some variable, the deterioration was largely temporary or related to the border conflict with Ecuador. Developments in 1996 seem to have returned to their previous path of stability; and developments in the first few months of 1997 have been positive, with higher growth and lower inflation.

The authorities should be commended for their persistent application of responsible fiscal policy, including restraint of government expenditure, careful monetary stance, and effective structural reforms. Even in the fields of pension and health services, where resistance to change tends to be greatest, they have followed a sustained course of action that will undoubtedly bear fruit in the near future. Other countries at the same level of development could, in many respects, imitate the Peruvian example as a model for overcoming some of their economic imbalances.

There are two areas in which it might well be appropriate for the authorities to be especially vigilant, namely, the current account balance and the financial health of the banking system. On average, the Peruvian economy has registered a deficit of 5–6 percent of GDP in its net current account balance of payments, which peaked in 1996 because of the conflict with Ecuador. The program for 1997 and 1998 calls for a relatively small decrease in that deficit of only a few decimal points; only beyond the year 2000 is a more substantial reduction in the deficit projected—if circumstances remain sufficiently favorable. Experience indicates that a continued current account gap of that size makes a country run the risk of provoking a change in investor sentiment and, therefore, a shift in the direction of capital movements. Increasing efforts to maintain international confidence are usually required with the passage of time, yet they become more and more difficult to apply. Of course, Peru's underlying situation seems to be far more solid than that of other countries that have ended up facing serious current account problems.

The authorities are neither explicitly nor implicitly committed to keeping a fixed parity for Peru's currency; thus, there is nothing preventing a market adjustment of the exchange rate when required, which should help to counter any speculative shift in capital flows. Furthermore, the staff notes in paragraph 22 of its report that two-thirds of total capital inflows financing the current account deficit are direct investment and privatization receipts. This assessment by the staff does not seem entirely consistent with Peru's high level of foreign currency denominated loans that, according to paragraph 9, seem to have provoked a substantial growth of bank credit to the private sector. The staff could usefully comment on that apparent inconsistency. However, in the final analysis, Peru does seem to have a stable source of financing for its economy, and there is nothing to suggest any immediate turnaround in foreign investor confidence. While there is no reason for immediate concern, the Board should suggest that the authorities stay alert to any early signal of a deterioration in exports or capital inflows, in order that they can take preventive measures well before the situation becomes difficult to manage.

Something similar could be said about the need to watch possible developments in the banking system carefully as well. The increase in credit figures in the financial sector over the previous four years has been really substantial. In comparison with the much slower growth in the monetary base indicates that Peruvian banks are intermediating large sums of foreign currency credits. Solvency risks tend to compound during episodes of strong credit expansion; and the predominantly foreign origin of bank resources also raises concerns fears about possible exchange and interest rate risks. In these circumstances, the authorities should strengthen prudential norms. While the creation of a superintendency of banks and insurance, and the strengthening of prudential requirements for financial intermediaries, are welcome steps, the authorities should also be encouraged to publish and enforce new regulations to increase provisioning for bad loans. It would be appropriate at present to analyze which measures could slow the rate of credit expansion, not only to avoid excessive banking risks, but also to prevent an overshooting of domestic demand. Indeed, it is important that Peru remains a model of stability and balanced growth.

I wish to ask Mr. Zoccali to convey respectfully to the authorities three points. First, I hope that they continue their administrative reforms, despite the recent rejection of a draft law by Congress; second, that they continue to make efforts to settle all payment arrears, especially those with other Latin American countries; and third, my best wishes to them in their continuing efforts to achieve social and economic progress in Peru. I support the proposed decision.

Mr. Fukushima made the following statement:

In the early 1990s, the Peruvian economy suffered from negative growth, and it was not until 1993 that the authorities' efforts began to show positive results. The economy is in the midst of a recovery process under the precautionary EFF program. What the authorities need to do now is keep the economy on the track of sustainable growth by focusing on structural reform. I would like to focus my comments on this point.

Real GDP growth in 1996 was 2.8 percent, which was slightly below the program target. In order for the poor to enjoy the benefits, annual growth of 5–6 percent will be necessary. In my view, there are three most important issues that need to be tackled.

The first is industrial policy. The Peruvian economy depends heavily on primary industries, such as agriculture, fishery and mining. As these sectors are vulnerable to price fluctuations, efforts to strengthen the manufacturing sector should be made over the medium- and long-term. Concerning the primary industries, there is still room for improvement and modernization, such as the supply of electricity to farming villages, and improvement of the irrigation system and roads.

The second issue is to reduce the fiscal burden. It is encouraging that the authorities have taken some modest measures in this area. In order to sustain these measures, fiscal consolidation should be implemented through expenditure cuts along with the strengthening of tax administration.

The third issue is to raise the saving rate. The saving rate in 1996 was 18 percent, which is much lower than that of Chile, which was 24 percent, and also lower than that of Asian countries.

On the external front, reactivation of the economy could worsen the external current account deficit. Further improvement in the nontraditional sector and in manufacturing will be the key to improving the competitiveness of the external sector. Continued privatization is important to further increase foreign direct investment. In particular, privatization of the mining sector, which has great potential, will be critical. The introduction of an import surcharge is somewhat disappointing. As the staff points out, this runs counter to the process of trade liberalization, and will have an adverse impact on foreign investment. In this regard, I welcome Mr. Zoccali's statement that the measure is only temporary and nondiscriminatory in nature.

On exchange rate policy, I welcome the authorities' intention to maintain the current float system.

On monetary policy, with a growth-oriented policy, it will be critically important to stem the tide of inflation. The current 12 percent inflation is still on the high side, and in light of the high rate of dollarization, continued tight monetary policy will be needed. With respect to the dollarization, as long as the central bank keeps a firm grip on monetary control and maintains sufficient foreign exchange reserves the dollarization will not be harmful to the economy. But in the long run, measures to strengthen the fundamentals will improve the credibility of the domestic currency.

As Box 2 in the staff report indicates, it is commendable that the authorities have been addressing poverty issues vigorously. The government announcement last week of a new strategy to reduce extreme poverty by the year 2000 is welcome. Greater equality of income will contribute to political and social stability, which is an important factor in sustainable growth and in foreign investment. In particular, the inequality of income between the urban areas and the mountainous farming areas should be reduced.

Finally, I would like to note that my authorities intend to provide continuous support to the efforts of the Peruvian authorities. With these remarks, I support the proposed decision and wish the authorities further success.

Mr. Grilli made the following statement:

The past year was undoubtedly a difficult one for Peru. Overall performance was below expectations. Output growth was below the lower range of the program; inflation was above its upper range, broad money growth was much higher than had been envisaged under the program, as was credit growth to the private sector; the trade imbalance was also larger than anticipated; interest rates remained above 20 percent in real terms, as they were in 1995; and employment continued to decline in manufacturing, although it rose in commerce. The staff has perhaps glossed over these difficulties too quickly in the papers.

On the positive side, fiscal performance improved notably, with the primary surplus of the consolidated public sector rising from 0.4 percent of GDP in 1995 to 1.2 percent of GDP in 1996, made possible by good revenue performance and adequate controls over expenditure. Nonetheless, fiscal adjustment was not achieved without cost, as it was accompanied by a slowdown in growth, which was also in part the result of a deterioration in the terms of trade. While remarkable progress was made in privatization, particularly of Petro Peru, and associated activities in the oil sector, there was a setback to the authorities' project to reform the state, which the parliament rejected.

Facing a difficult situation, the government relaxed fiscal policy in 1997, by reducing taxes on the private sector and lowering somewhat the external tariff, to help restore growth. It is significant that the path of fiscal consolidation has since slowed down, and practically halted: the projected increase in the primary surplus of the public sector for 1997 is too small to be of any significance. Even so, economic activity is already showing signs of picking up and inflation is slowing down, which augure well for the current year, particularly if the projected further small decline in the external current account deficit materialize. The debt and debt-service reduction operation with commercial creditors ended in March; and the conclusion of negotiations with official creditors on the July 1996 Paris Club rescheduling agreement are also helping. On the structural policy front, the authorities aim at furthering the privatization process and achieving considerable progress in the areas of health and pension reforms, and absorbing the cost of these reforms on the budget.

The latter are achievable objectives, though the margin for error in both the trade and budgetary areas is slim, as Mr. Toribio has noted. There could be under performance in both of these areas, which should be kept under control. While the outlook appears to be reasonably favorable over the short term, the achievement over the medium term—in the authorities' words—of "conditions of sustained output growth with reduced poverty", lower inflation, and external viability is subject to considerable risks, and will require continued broad progress on a variety of fronts. Achieving all of these objectives over the period of 1998–2000, for example, will require adequate fiscal policies, major increases in export growth—exceeding 10 percent a year in volume terms, implying the provision of adequate incentives for production of tradables—containment of import growth to about 4.5 percent a year, or well below envisaged GDP growth of 6 percent, implying therefore an import elasticity of demand of considerably less than unity. It will also require that no severe terms of trade shocks take place, and a continuing ability to finance current account deficits remaining in the range of 5 percent of GDP which, though manageable, is substantial and close to the danger zone. The experience of other countries indicates that current account deficits exceeding 5 percent of GDP considerably increases the probability of payments difficulties. In the case of Peru, this means that continued foreign direct investment is critical to finance the current account deficit. Moreover, as privatization receipts will diminish over time, continued private direct investment flows will become even more important.

Peru thus needs continued good policies, starting with sound fiscal and monetary policies, including tight control of nonproductive expenditure, especially military expenditure, and of the public sector wage bill. However, the legitimate question over the next few years is, will the internal security situation and the presidential political cycle allow such tight control? Peru will also need a competitive exchange rate, and private sector investment in traditional and especially nontraditional export industries, otherwise the required increases in export volume growth of at least 10 percent a year will not be achieved easily. Peru also needs continued tariff liberalization, (possibly without distortions). Finally, Peru needs to retain the confidence of foreign direct investors at high levels, which will depend on continued success in structural reforms, macroeconomic stability, and on a stable political situation. While these would seem daunting requirements to meet, Peru has shown over the previous year that it not only has the ability to meet them, but also to more than meet them, or to overperform. That being said, the challenges that it will face over the medium term should not be underestimated. Meeting these challenges requires sensible policies, a clear vision, and steadiness in pursuing them. There is little margin for policy detours—owing either to impatience, failure, or a desire for quick fixes—in meeting these challenges. Thus, what is required is a high degree of political cohesion to ensure that wise decisions are taken, oriented toward the public good and shared by all segments of society.

Mrs. Coronel made the following statement:

Economic growth in Peru has been impressive. Even taking into account the substantial reduction in the pace of output growth in 1996—attributable to a slowdown in domestic demand and a deterioration in the terms of trade—real GDP increased at an average rate of 7.3 percent in the period 1993–96 and is expected to further advance by 5 percent in 1997. At the same time, inflation was dramatically reduced—it reached one digit levels in May—and the social indicators showed some improvement although the poverty level is still a matter of serious concern.

The macroeconomic discipline and the strong agenda of structural reforms undertaken by the Peruvian authorities played a key role in these developments, as did the willingness of the people to fight inflation and reactivate economic activity after the painful experience of the 1980's. Nevertheless, achievement of Peru's medium-term objectives will require continued discipline and a deepening of the structural reform effort. In this context, we welcome the authorities' actions to proceed with the reforms in the agricultural sector, and their intentions to go ahead with the privatization plans and advance in the reform of the state.

On recent developments, we note that all performance criteria for end-1996 were met. Public finances were strengthened as a result of an improvement in public sector revenue including value-added tax collection. It is essential for the authorities to maintain a tight fiscal stance, to strengthen expenditure management, and to improve the quality of public spending in such a manner that a higher proportion is devoted to the social area. In this regard, like other speakers, we are encouraged by the recent government's announcement of its strategy to halve extreme poverty by the year 2000.

Fiscal tightening helped reduce the external imbalances. The reduction observed in the current account deficit in 1996—resulting from a smaller trade deficit and lower interest payments—as well as the comfortable level of international reserves, should send positive signals to economic agents. Nonetheless, the current account deficit is still quite high and the level of domestic savings needs to be strengthened.

The structural reforms and fiscal tightening measures being implemented by the authorities have been supported by a comprehensive debt restructuring operation with commercial creditors and by the conclusion of all bilateral negotiations in implementation of the Paris Club rescheduling. The debt relief achieved with these operations should allow the country to devote additional resources to development and social projects.

On the monetary front, we are a bit concerned with the growth of bank credit to the private sector, as well as with the slight increase in dollarization. In fact, credit growth took place mostly in foreign currency denominated loans, and was significantly higher than envisaged. A close monitoring of short-term capital inflows and the new regulations for bank provisioning should help slow the rate of credit growth and avoid its adverse effects in stability and in the health of the financial system.

Finally, we would like to congratulate the authorities for the sound performance of the Peruvian economy and endorse the proposed decision.

Ms. Lissakers made the following statement:

A year ago when we reviewed Peru's economic progress, the Board cited Peru as an example of what can be accomplished if a government systematically carries through fundamental economic reforms, including critical structural measures. We are pleased to see that the authorities remain committed to this task and that considerable progress has been made during the past year. Reform performance under the first year of the Extended Arrangement was strong, and although growth in 1996, and by extension social welfare, suffered from the shifting of resources from investment to unproductive military expenditure, an incipient recovery appears to be under way and 1997 promises to bring greater returns, provided the government maintains prudent macroeconomic policies, keeps a lid on military expenditures, and pushes through further structural reforms. We broadly support the authorities' efforts, and agree with their approach to the Extended Arrangement as a precautionary arrangement. Let me just note a few specific points.

We agree with the staff that Peru's medium- and long-term success hinges to a significant degree on the prudent conduct of fiscal policy. I just noted our concern on higher military spending, and I am somewhat reassured to hear that the expenditures in this sector will be kept in check in 1997. We hope that there will be some reduction in the short to medium term, however.

The staff emphasizes expenditure compression as the primary means for fiscal consolidation. We certainly agree that there is room for continued improvement in the expenditure control, and we would urge the authorities to reinvigorate the process of civil service reform and consider removing the monopoly of the Social Security Institute to allow for private sector participation in the provision of secondary health care and hospitalization services which account for a large part of spending in this area.

Given the need to expand social sector outlays, however, I am pleased to see that the Peruvian authorities are devoting more public resources to the areas of primary health and education. Further, it seems to us that the burden of fiscal consolidation will have to fall just as heavily on revenue enhancement. Although Peru benefited last year from better than expected nontax revenues, including privatization deposit interest income and profits of public enterprises. This helped to offset the expenditure overruns stemming from purchases of military equipment in 1996, but the repeat of this windfall, if you will, in 1997 is by no means guaranteed. It seems to us that a permanent expansion of the tax base is in order. Tax revenues as a share of GDP, at roughly 14 percent, are improving, but they are still quite low, and we are struck by what seems to us a fairly unambitious goal of keeping 1997 tax revenue steady as a share of GDP relative to 1996. This may in part reflect the government's decision to reduce the rate of tax on assets from 2 percent to 0.5 percent. We certainly understand the desire to reinforce the incipient economic recovery, but we wonder whether the reduction is warranted given that the first quarter data shows quite a strong pickup in growth already. In any event, we concur with the staff that any further reduction in tax rates should be delayed until there is strong evidence of an improvement in the overall fiscal position beyond program targets.

We are pleased to see that the authorities intend to fully implement the package of tax administration measures recommended by Fiscal Affairs Department, and maybe that stronger collection efforts will leave some room for some modification of tax rates down the road. But I do not think it is something that the authorities should rush into.

Monetary policy appears to be appropriately tight to achieve the goals for inflation reduction. However, given the heavy dollarization of the economy with dollarized bank assets and liabilities somewhere in the 75 percent range, it would seem that domestic monetary policy has less to do with management of monetary aggregates than with effective banking rules and prudential supervision. I do note that there is a very high reserve requirement on foreign currency deposits in the banks which helps to moderate the credit expansion. However, the high domestic currency interest rates have only a marginal impact on credit growth and credit demand, given that most of it runs on a dollar chassis which is priced differently. I wonder if the staff would elaborate a little bit on the dilemma of managing monetary policy with this high level of dollarization and whether they regard the reserve requirement on dollar deposits as a sufficient tool for managing the inflow from a monetary policy standpoint.

I agree very much with the comments Mr. Toribio made in general on prudential supervision, and I want to associate myself with the other recommendations he made. However, I have one question about the note that the Peruvian authorities have requested technical assistance from the Fund in formulating an action plan to strengthen banking supervision. I wonder what the World Bank is doing in this area with Peru, if anything, and why they have come to us rather than the Bank.

On the balance of payments, I agree with some of my colleagues that the current account deficit is still quite high although certainly improved from 1995, it seems to us that further adjustment is needed. Export diversification would obviously improve the economy's resilience over the medium term. However, the continued reliance on primary commodity exports, copper and fishmeal particularly, in the short run leaves the country vulnerable to real balance of payments shocks, and I wonder if the staff has any concerns about the recurring effects of El Niño, which could disrupt particularly the fishing industry and what the implications would be for the external balances. If there is a disruption, what measures would you recommend to the Peruvian authorities to maintain the improvement in the current account balance?

The current account effort is consistent with the Extended Arrangement target, I realize that, but it may be that the target is a little unambitious. It certainly is another argument for additional fiscal consolidation, as the staff report argues.

I agree with Mr. Toribio that the flexible exchange rate policy is a very sensible policy for the Peruvians to have and it gives them the flexibility to deal with fluctuations in the external accounts. Continued use of the flexible exchange rate in combination with steady progress on disinflation will be the key to maintaining Peru's export competitiveness, and enabling the country to diversify its export base. We agree with Mr. Grilli that the Peruvian authorities have made commendable progress on the privatization front, and we support the ambitious agenda the authorities have mapped out for further sales this year. We also welcome the authorities' intention to begin awarding the provision of public services to private sector firms, and the passage of legislation to enforce compliance with contracts and environmental standards. We also noted in Mr. Zoccali's statement that the authorities recently issued regulation for implementing the land tenure and promotion laws and this should encourage faster and more equitable growth in this sector that could make a big difference in the standard of living for the poorest segment of the Peruvian population.

The trade regime seems to have taken one step forward and one or more steps backward. We certainly welcome the reduction of the average in the port tariff rates. The introduction of 5 percent import surcharge on certain agricultural production lessens the value of this move. We understand that this was a political compromise, but we agree with the staff that the authorities should consult with the WTO on the elimination of the surcharge, and I also wonder whether the staff or Mr. Zoccali can elaborate a bit on the decision to withdraw from the ANDEAN group and what the prospects are for membership in MERCOSUR. And just to return for a moment to the imports surcharge, it is supposed to be temporary. I wonder if the staff or Mr. Zoccali can tell us when it will be lifted.

Mr. Blancher made the following statement:

I welcome the recent progress in the adjustment process and the authorities' successful efforts to cool down the economy in 1996. Despite unexpected price shocks in 1996, the process of disinflation seems well on track. The most recent figures are particularly encouraging, reflecting efficient monetary tightening.

But, again this year, stricter control of base money has not prevented rapid growth in broader monetary aggregates, which corresponds to very sharp increases in foreign currency deposits and private credit in dollar, close to 50 percent in 1996. As staff indicate, this is largely the result of a combination of higher private capital inflows, and growing remonetization and reintermediation leading to increased dollarization. Apparently, it has not led thus far to excessive demand pressures, since no inflationary tensions or massive rise in imports have occurred. Nevertheless, while I agree with the staff that the recent deterioration in the prudential ratios of banks is already a particularly worrisome trend, I am surprised that the staff give no thorough analysis of the potential risks, particularly on the external front, stemming from these recent evolutions and of the preventive stance that the authorities should adopt at this very moment. Indeed, the fiscal tightening could, in the event, prove insufficient in offsetting demand shocks that would stem from a continuation of the credit boom. Accordingly, stronger action on the monetary front and on banking regulation is needed to check such mounting uncertainties.

First, strengthening prudential regulations in the banking sector should be a top priority, particularly regarding provisioning requirements in the current context of rapid credit growth. In this respect, I welcome the recent adoption of the banking and superintendency of the Banking Law, and I agree with the staff that issuing new regulations should not be delayed.

Second, at the same time, reserve requirements should be more actively relied upon in order to check dollar-denominated credit. I note that the authorities have proceeded twice to reduce the remuneration rates of reserves on foreign currency deposits. But raising the levels of reserve requirements is a more decisive step that should be taken to prevent an excessive increase in demand. Obviously, caution would be needed in view of the present size of the current account deficit and, as shown in a 1992 working paper from the Policy Development and Review Department, higher reserve requirements should apply only to that part of the dollar deposits that is locally lent in order to avoid excessive disincentives to the repatriation of assets. In the short term, higher reserve requirements could also lead to a shift toward external borrowing but, like Ms. Lissakers, I would like to have the staff's views on the fact that it would also probably be a strong incentive for banks to slow down the growth of domestic dollar-denominated credit.

Mr. Daïri made the following statement:

Peru's adjustment and reform program, supported by two Extended Arrangements, has met significant success with a very rapid disinflation to a single-digit level, buoyant growth, strong external position, and normalization of relations with creditors. All performance criteria of the first year program were met with margins. These achievements resulted from a steadfast implementation of tight financial policies and market-based structural reforms. The authorities' comprehensive approach to adjustment and reform and the strong political will in policy implementation, as indicated by Mr. Zoccali in his comprehensive and helpful statement, bode well for continuous success. I concur with the thrust of the staff's assessment and wish to make a few comments.

Fiscal consolidation is high on the authorities' agenda. In 1996, the primary surplus of the public sector exceeded the targeted level. I agree with the staff that the major emphasis should be on expenditure restraint, and I welcome the authorities' efforts to reduce unproductive expenditure and stabilize the wage bill. Although the wage bill in Peru is not very high by international standards, a reform of the civil service, as suggested by the staff, would go a long way in strengthening fiscal sustainability and improving efficiency of government services. While I agree with the staff that any further reduction in tax rates should be considered with caution, the feasibility of such measures should be assessed against progress in broadening the tax base and improving administrative efficiency, and not only against overall progress in fiscal consolidation as suggested by the staff. A reduction in rates that would improve revenue collection should be considered regardless of expenditure developments.

The authorities are to be commended for the skillful debt restructuring that substantially improved debt indicators and the balance of payments viability. While I welcome the reduction in the current account deficit in 1996, consideration should be given to a further reduction as suggested by Mr. Toribio. I am pleased to read from Mr. Zoccali's statement that growth of nontraditional exports has increased significantly in early 1997, and that imports of capital goods have resumed in line with strong economic recovery.

The expansion of credit to the economy in 1996 is not fully understandable since it did not result in significant acceleration in inflation or pressures on the balance of payments. The predominant and increasing share of foreign currency in deposits and credits requires close monitoring. The high interest rate on these deposits and the large intermediation spread—partly due to low remunerated required reserves—should be reduced to avoid jeopardizing the quality of banks' portfolios. I welcome the authorities' efforts at enhancing bank supervision and tightening prudential regulations, including the enactment of a new Banking and Superintendency of Banks Law. I wonder if the staff has considered other instruments for controlling expansion of foreign currency credits since, like Ms. Lissakers, I have some doubts about the efficiency of the required reserves.

The authorities' efforts at improving social services and reducing poverty are noteworthy and should strengthen the sustainability of the adjustment program and improve long-term growth prospects.

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

Mr. Qi made the following statement:

I commend the Peruvian authorities for the progress they have made in the first year of their 1996–98 program and the conclusion of their DDSR operation with official and commercial creditors. We share the staff's view that the authorities' 1997 program deserves the Fund's support and we have no difficulty in approving the proposed decision.

As I am in broad agreement with the thrust of the staff appraisal, I would like to limit my statement to three points for emphasis. First: the current account deficit. It was 5.8 percent of GDP in 1996, and was programmed to be 5.3 percent of GDP this year. This is a hard task, given the pickup in economic activity and the reduction in external tariff rates which might entail a boost in imports. In order not to resort to import restrictions, it is essential for Peru to enhance the productivity of its industries and the competitiveness of its products, and to increase export diversification.

Second: capital inflows. Peru's current account deficit is well financed by private capital inflows. Nonetheless, we find that, in recent years, among those inflows, portfolio investment and short-term private capital (including errors and omissions) account for a large portion. Should these volatile capital be excluded, the capital account surplus could not cover the current account deficit. It is advisable to keep an eye on the movement of this capital.

Third: the soundness of the banking system. In the course of an economic upswing, an expansion of bank credit is often seen, which will result in the build-up of inflation pressures and possible loan defaults. Under these circumstances, we would like to see the prudential ratios of banks in Peru strengthened rather than the contrary. Any problems in the banking sector might trigger disastrous consequences for the sector itself, for capital movements, thus the external sector, and even for the whole economy. In this connection, the authorities are encouraged to closely regulate and supervise the banking system.

With these comments, I join other speakers in wishing the authorities well in the future.

Ms. Akhmetova made the following statement:

I broadly agree with the staff appraisal. The authorities are to be commended for their continued strong pursuit of economic reform. Since the last Article IV consultation, no significant complications have emerged: Peru's economic performance has satisfied the expectations of the Fund-supported program, and some major stumbling blocks to Peru's sustainable long-term development have been removed.

In addition, the Fund's support has aided Peru to conclude rescheduling agreements with most of its external creditors. That formal signal of confidence on the part of official donors and commercial creditors has led to normalization of Peru's external debt situation and paved the way for its macroeconomic rehabilitation.

I would just like to submit a few thoughts for the Board's reflection.

Fortunately the GDP growth slowdown during 1996 reversed itself late in the year and the economy needs no stimulation. I agree with the planned fiscal tightening, which should add to the revenues generated by the determined privatization efforts of recent years. Meanwhile, we are concerned to note that excess spending is being covered by privatization receipts. This is only a temporary solution, and we urge the authorities to avoid such overruns in future.

From a broader standpoint, the maintenance of a primary balance surplus for the last five years, together with continuing efforts to clear up Peru's external debt problem, are grounds for optimism about the country's fiscal situation. But this optimism is no reason to slow down the reformation of the government, and we urge the Peruvian authorities to accelerate the pace of civil service reforms and governmental reorganization. Rapid reform of state institutions should promote better governance by reducing opportunities for rent-seeking and corruption.

We would also like to see an end to delays in the introduction of the Integrated System of Financial Administration. Several countries have already benefited from similar efforts jointly undertaken by the Bretton Wood institutions, and even though the recent complex reformation of the complex tax administration shows that Peru's administrative capacity is adequate, we wonder if the staff thinks assistance from the World Bank would be helpful.

Eliminating redundant budgetary organizations from the budget would make it possible to increase civil services wages and to redirect more resources toward long-promised government efforts to alleviate poverty, by extending upward the admirable policies that now provide strong protection and support only to the very poorest segments of society.

Given that the informal sector dominates Peru's economy, including the dynamics of the general wage level and labor costs, we agree with the staff that further increases in the minimum wage should be approached with caution.

As to monetary and banking developments, the continued growth of credit to the private sector is welcome insofar as it indicates a growth in intermediation. I understand the authorities' concern that credit growth that is faster than GDP growth could increase inflationary pressures. But with Peru's level of monetization is still much lower than that of other countries in the region, a continuation of financial deepening should be welcome.

In the area of foreign trade, the introduction of an import surcharge is worrisome. The commitment to an open trade regime shown by the reduction or elimination of trade distortions should be encouraged and continued. The gains available from temporary surcharges should be weighed against their probable costs in terms of lost credibility and investor confidence.

Export growth slowed sharply in the past year, mostly due to worsened terms of trade. But the decline also signals that Peru's capital inflows—mostly FDI—have not yet produced sufficient export diversification, though the share of nontraditional exports has been increasing. The authorities' efforts to encourage exporting industries are therefore appropriate, though care must be taken that special incentives for new industries do not lead to distortions and losses of competitiveness.

This being said, I support the proposed decision and hope that Peru's recent achievements will lay the foundation for continuing the reform agenda.

Mr. Kaufmann made the following statement:

We welcome the Peruvian authorities for the progress achieved during the first year of the Extended Arrangement and support the proposed decision. The objectives for the second year are ambitious: it is intended to decrease inflation toward the level achieved by industrial countries, to strengthen the external position, and to reduce poverty.

On the occasion of the last Article IV consultation with Peru in December 1995, many directors were concerned about the weakened external position and urged the authorities to step up fiscal consolidation in order to expand domestic savings. We are glad to hear that the developments in 1996 and early 1997 were favorable in this respect. The primary fiscal surplus has increased and the composition of imports looks more healthy, with the share of capital goods imports increasing due to strong foreign direct investments. There is a good chance that these investment projects will become profitable over the next years. With this in mind, the staff's medium-term projection of an annual 10 percent increase of export volume looks reasonable.

We are satisfied that the government's overall strategy aims at achieving a high rate of economic growth. A sound macroeconomic environment and specific measures to foster private sector activity—to mention only the lowering of the tax burden for private enterprises—will help increase both foreign and domestic investment. This, together with intensified competition through privatization and lower tariff protection should boost productivity. However, while strong productivity increases will allow to raise real wages and thus domestic demand without fear of a surge in inflation, the effects on employment are less clear. Does the staff have any estimate about labor market developments in Peru under the assumptions of the medium-term scenario?

While high growth rates will facilitate the reduction of poverty over the medium-term, further policy measures are needed to improve the living conditions of the poor. It is encouraging that the authorities have increased social expenditures and are working on making them more effective. We look forward to the study on poverty for the period 1994–96 and hope that the situation has improved relative to the period 1991–93. Most observers admit that progress has been achieved in this area, but many of them wonder if not more could be done. For example, the U.S. Ambassador in Peru recently questioned Peru's purchase of war planes from Belarus, saying that the money could have been better spent for schools and roads. We would appreciate the staff's comments on the poverty issue, especially also if staff have thought about the relationship between income and wealth distribution and poverty in Peru. Maybe also in this context, we are interested to know more about the rationale behind the lowering of the asset tax from 2 percent to 0.5 percent. Does this really make sense in the case of Peru?

Once macroeconomic credibility will fully be established and sound rules for private sector activities have emerged, the shape of the Peruvian institutions will become the major focus of investors. Thus, it is important to continue the modernization of the state. It is unfortunate that reforms in this sector have stalled. Thus, we ask the authorities to seek new ways that make a streamlined civil service and leaner administrative procedures a common goal of the major political forces.

The role of the banking sector in emerging markets plays a crucial role. In this view, it is worrisome that the prudential ratios of banks have deteriorated recently. We hope that the authorities take this issue seriously and that the new regulations for banking provisioning address this problem adequately. Some observers link yesterday's resignation of Manuel Vasquez, Peru's superintendent of banks and insurance, to diverging views between him and the president over changes in banking laws and regulations. Does the staff know more details about this issue?

With these remarks, we wish the authorities well in their future endeavors.

Mr. Trivedi remarked that Peru's performance over the previous year had been broadly satisfactory, and he especially wished to commend the authorities for their successful fiscal consolidation. Given Peru's track record, the 1997 targets for inflation and growth seemed to be achievable. He broadly agreed with the thrust of the staff report and supported the proposed decision.

The staff had noted that Peru's current exchange rate arrangement had served the country well, Mr. Trivedi remarked. Yet it was surprising that the nominal exchange rate had remained relatively stable in 1996, despite the bullish external sector, including large capital inflows, rising international reserves in the central bank, and large nontraditional exports. In light of those circumstances, he wondered whether it was possible that the currency was undervalued. If it was, continued growth of exports at the current rate might be sustainable, and the authorities' might not realize their desire of keeping the current account deficit under control.

Ms. Honeyfield asked the staff how Peru might be affected by possible instability in other parts of the region and what measures the authorities could take as a result. Moreover, she wondered how rising interest rates in a number of industrialized countries might affect the level of foreign investment in Peru.

The Deputy Director of the Western Hemisphere Department commented that the rapid credit growth in Peru was a cause for concern, though it was being driven in part by reintermediation in the banking system. As Mr. Zoccali had noted, monetary aggregates had increased from the equivalent of about 6 percent of GDP to about 20 percent of GDP, or about the level reached in the 1970s, and still below the level typical in middle-income countries. Even though the performance criteria under the program were based on net domestic assets, the authorities closely monitored developments in monetary aggregates and credit. In light of their concern at the rapid growth in foreign-currency denominated credit, they had reduced the remuneration rate on reserve requirements in September 1996, which had been followed by a further two reductions, with the rate currently standing at LIBOR minus 1⅜ percent.

While dollarization limited the effectiveness of monetary policy, the authorities were proceeding appropriately in imposing reserve requirements on dollar-denominated deposits, the Deputy Director continued. The staff believed that they should also improve bank provisioning, and perhaps also increase the capital ratio of banks. The World Bank was not currently assisting Peru in banking supervision, and the Inter-American Development Bank was mainly providing assistance for computerization of the superintendency of banks. In that connection, he had learnt from a conversation with the Finance Minister the previous day that the government would accept the resignation of the Superintendent of Banks. There had appeared to have been conflicts between the Superintendency of Banks, the central bank, and the finance ministry, and lack of coordination between them in formulating the new banking law. The finance minister hoped that the resignation would allow the government to proceed with adopting the loan provisioning regulations, including a general provision on all loans, and perhaps an increase in provisioning on certain types of loans.

The authorities believed that the reduction in the asset tax—equivalent essentially to a minimum contribution to the income tax—was warranted, given the need to broaden popular support for the program at a critical juncture, the Deputy Director added.

While the authorities were concerned about the potential impact of El Niño, it should be noted that performance under the program had hitherto been better-than-expected in terms of fiscal revenues and expenditures, the Deputy Director pointed out. Moreover, net international reserves had increased thus far in 1997, the trade deficit was narrowing, and growth had picked up. With their better-than-expected performance in the fiscal area, the authorities were building up margins in case El Niño caused problems later in 1997. Some forecasts indicated that El Niño might begin to have a substantial impact toward the end of 1997, and the authorities had begun to direct expenditures to areas that might suffer from flooding. As forecasting El Niño was highly speculative, it was too early to estimate the seriousness of its impact.

Peru was an associate member of the Andean Group, but had not yet formally left that group, the Deputy Director indicated. Peru had intended to join the Group as a full member, but was discussing several issues with other members first, such as the timing of full adoption of the common external tariff, the use of nontariff barriers within the Group, and the application of norms of origin. The authorities argued that the Group had four rates in its external common tariff, which were more dispersed than Peru's two tariff rates, which the authorities aimed to reduce gradually in moving toward a uniform tariff structure. Subject to final clarification of its status in the Andean Group, Peru was continuing to trade with other members of the Andean Group via bilateral agreements, each lasting about one year. The authorities had begun preliminary discussions with other countries in the region. They hoped that they might secure an agreement with Chile first, and intended to strengthen their ties with MERCOSUR.

As some Directors had noted, it was regrettable that the authorities had introduced import surcharges for political reason, while reducing tariff rates, the Deputy Director said. The authorities had recognized the concern of the Fund about those surcharges on certain agricultural products, and had indicated that the latter were temporary, stating that they were perhaps a necessary price to pay for reducing the main two rates. They were beginning to consider alternative means of addressing the difficulties of small agricultural exporters—perhaps by introducing limited and well-targeted subsidies—which might help them to eliminate the surcharges. While it was unclear when those surcharges would be eliminated, the staff had indicated to the authorities that it was an important issue that the Fund would address at the next review.

A major balance of payments or exchange market crisis in one of the major Latin American countries could reduce confidence in Peru and potentially provoke capital flight, the Deputy Director noted. While Peru had not been affected much by the Mexican crisis of 1993–94, that did not necessarily mean that it would not be affected by a similar crisis in the future. Most of Peru's exports were directed outside of Latin America, meaning that the country would not be affected much by a shock in trade patterns in the region. The improved investment climate in industrialized countries might negatively affect foreign investment in Peru to some extent, though, to the extent that foreign investment was being directed largely at Peru's mining sector, the risk was not a major one.

As for the question about the apparent inconsistency between the fact that capital inflows consisted mainly of foreign direct investment and the fact that dollar deposits had grown substantially, one had to consider the entire capital account, the Deputy Director remarked. In addition to foreign direct investment, there were substantial short-term capital inflows of about $1 billion in 1996. One source of the increase in dollar deposits might be an underestimation of the external current account, or underinvoicing of export receipts from illegal trade. Another source was the process of remonetization. To some extent, balances held in dollars reflected resources for long-term foreign direct investment deposited temporarily in the banking system.

The staff expected a gradual reduction in unemployment over the medium term, based on economic growth of 6 percent a year, including agricultural development and the effects of continuing foreign investment in mining and other sectors, the Deputy Director explained.

Some progress had been made in dealing with poverty, though more needed to be done. The authorities were aware that the Fund favored a further increase in fiscal revenues as a ratio of GDP over the medium term—and in fact were intent on strengthening tax administration—which should free more fiscal resources for social expenditures. Continued reform of the state would also have the same effect. A macroeconomic framework conducive to sustainable growth, together with increased fiscal revenues, would be consistent with growth in employment and a gradual reduction in poverty.

Mr. Grilli noted that staff had assumed export volume growth of 10 percent a year and import volume growth of 5 percent a year, yet had projected continuing current account deficits of about 5 percent of GDP. The staff had discussed the risk of external shocks such as El Niño, but he wondered about the size of the risks—or margins of error—for the program from underperformance in trade.

The Deputy Director of the Western Hemisphere Department commented the medium-term projections were subject to risks, if some of the projected exports did not materialize or grew at a slower-than-expected rate. In the event, one would hope that there would be corresponding adjustments in imports, given that the bulk of exports were generated in the private sector. That being said, the projection of relatively rapid growth in exports was based on continuing export diversification. New sectors were beginning to export, such as the textiles sector, which had assumed a large share of Peru's exports. Furthermore, over the medium term, there would be substantial, long-term foreign direct investment in the mining, natural gas, and iron sectors. The projections had been carefully formulated with the authorities, taking into account the latter's expectations regarding the timing of investment projects financed from abroad, which would generate additional exports. To minimize risks to the program, it was vital that the authorities continue a prudent fiscal policy. One should keep in mind, moreover, that the Peruvian public sector had virtually no short-term debt, either internal or external, except for the public enterprises, whose debt accounted for less than 0.1 percent of GDP. That provided some assurance in the event of external shocks.

Mr. Brooke asked the staff for clarification of its view on the Fund's role in providing technical assistance in banking supervision. The two reasons cited by staff for providing Peru with such technical assistance—that the authorities believed the Fund had expertise in banking supervision, and that the Bank was not already providing such—were not criteria that the Board had agreed in its discussion on the creation of a sound banking framework (EBM/97/30, 3/28/97). To his understanding, the Board had agreed that, if the World Bank was not involved in a country at all, rather than necessarily in the banking sector per se, the Fund should provide such assistance; and it should also do so if a crisis was looming in a country. He recognized, nonetheless, that the Fund and the Bank were still discussing the provision of technical assistance in banking, and that there were no definitive guidelines yet.

The Deputy Director of the Western Hemisphere Department responded that, although there was no imminent crisis in Peru, the ratio of nonperforming loans to total loans had increased. The authorities needed help in establishing the new provisioning regulations under the new Banking Law, issued in December 1996. In its discussions with the authorities, the staff had emphasized the importance of tightening the provisioning requirements, given current conditions in Peru; and the Minister of Finance had requested technical assistance to that end. Hitherto, the staff had sent a mission to check the authorities' needs, but had not decided on any follow-up, and would coordinate with the World Bank. The Fund and the

Bank would have to decide whether or not to provide technical assistance and, if so, which institution should provide the assistance.

Mr. Zoccali said that he wished to thank Directors for their continued support of the Peruvian program, and that he would convey their constructive comments to the authorities. The Fund should remain involved in the area of banking supervision because it had played an instrumental role in the design of the 1996 Banking and Superintendency of Banks Law, which had major macroeconomic consequences, as it was aimed not only at prudential regulations, provisioning standards, and minimum capital requirements, but also at controlling money laundering, for example. In that connection, the authorities had announced that the effective minimum risk weighted capital asset ratios would be increased in two stages, first by 8.7 percent on July 1, 1997, and second by 9.1 percent on January 1, 2000. Given the Fund's involvement in the banking sector already, which had been useful, the authorities hoped that the Fund would continue to assist their efforts.

While one could not deny that there were medium-term risks to the program, the authorities have been relatively successful in reinvigorating investor confidence through deregulation, liberalization, and privatization, Mr. Zoccali continued. The result had been ample financing for Peru, notably substantial, and long-term foreign direct investment. In the short term, imports had increased sharply as result of the latter investments, and thus it was unavoidable that the current account deficit had increased substantially. As investment projects matured, they would generate strong net export earnings, and gradually contribute to a reduction in the current account deficit, as projected in the medium-term scenario. Moreover, privatization was continuing, and investor confidence remained strong. In the case of an external shock, Peru should cope relatively well, given its sizable net international reserves, and the fact that the country had virtually no short-term domestic public debt (equivalent to only 0.1 percent of GDP). The authorities had maintained a transparent policy regarding the evolution of [ ] and of basic economic indicators, implying that there should be no surprises in that area. Furthermore, the authorities' strong record of policy implementation provided Peru with another safeguard.

The issue of defense expenditures should not be exaggerated, as military purchases in 1996 had been done within the fiscal parameters of the program, Mr. Zoccali emphasized. Despite those military purchases, the primary fiscal balance was in surplus, and, in fact, had strengthened by 1.1 percent of GDP in 1996. Furthermore, the UNDP *1997 Human Development Report* indicated that total defense expenditure had remained unchanged at 1.6 percent of GDP in 1995, or one of the lowest in the region. That fact illustrated the authorities' commitment to improving the quality of public expenditure and to developing, in particular, human capital and basic infrastructure, which were the basis of the president's strategy for poverty reduction.

To some extent, the process of de-dollarization was difficult to understand, Mr. Zoccali stated. Initially, the value of the domestic currency had had virtually no credibility—hence the previous hyperinflation. Consistent reduction of inflation, which the authorities were committed to unequivocally, was a prerequisite for the reduction of dollarization. It should also be kept in mind the limited capacity of monetary policy to influence domestic interest rates in a small open economy. In any event, dollarization had had some beneficial effects on Peru and other countries, as it had fostered financial deepening through growth of foreign currency deposits and credit, which otherwise would have been intermediated [elsewhere]. It had also facilitated opening of the Peruvian banking system, allowing greater access by the private sector to credit and had reduced the fragility of the financial system. The opening of the banking sector had led to increased competition, asset diversification—implying lessened vulnerability to domestic macro shocks—and increased and more permanent access to foreign credit lines, which should also reduce the vulnerability of the financial system in the event of a crisis. Of the 23 banks operating in Peru, 20 had substantial foreign shareholders (the foreign share exceeded 50 percent in 11 of the 23 banks).

Despite the import surcharges, Peru was observing all of its commitments under the WTO agreements, Mr. Zoccali pointed out. The surcharges were not discriminatory; applied to about only 5 percent of total import tariff classifications; and tariffs in no case exceeded the maximum permitted. The fact that the authorities' had chosen to use import surcharges to increase the effective level of protection indicated the temporary nature of the measures, which had been adopted for a transition period only, in which the government would seek to increase the competitiveness of Peruvian agriculture. To that end, it had also announced an agricultural promotion law.

Mr. Grilli commented that the staff's projections tended to favor Peru in two respects: first, in forecasting rapid export growth, driven by previous investment; and second, in forecasting a low elasticity of imports to GDP. The fact that Peru was being given the benefit of the doubt in both respects had prompted his concern about program risks. He did not doubt the country's capacity to sustain export growth of 10 percent a year, but seriously questioned the economy's capacity to grow by 6 percent a year while sustaining only 4½ percent import growth a year.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their successful and sustained implementation of sound macroeconomic policies and wide-ranging structural reforms in recent years. They noted that significant progress had been made in 1996 in terms of tightening financial policies, which had helped to narrow the external current account imbalance, reduce inflationary pressures, and pave the way for the resumption of stronger economic growth.
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> Directors emphasized that the maintenance of a tight fiscal stance was essential to contain demand pressures. They commended the authorities for the improvement in tax collections in early 1997 and encouraged them to proceed steadfastly with the strengthening in tax administration to offset the revenue loss from lower tax and tariff rates. Directors welcomed the efforts of the authorities to tighten fiscal expenditure in 1997 and strictly control noninterest current spending, including the wage bill; a few speakers also called for keeping tight control over military spending. They noted that those reform efforts should help release resources for the needed increase in social spending and for stepping up the fight against poverty and reducing income inequality. Directors emphasized that it would be important to regain momentum in the reform of the state, to streamline the civil service, and strengthen budgetary management. Some Directors considered that more ambitious fiscal targets would have been desirable, and encouraged the authorities to achieve a better-than-programmed fiscal outcome.

Directors expressed some concern about the high growth rates of broad money and domestic credit; they considered that credit to the private sector should be monitored closely to avoid excessive demand pressures and to ensure the soundness of the banking system. Given the recent deterioration in some of the prudential ratios of banks, Directors emphasized the need to strengthen the supervision of financial institutions in order to promote a sound financial system and effective financial intermediation. They called for the early enactment of regulations aimed at strengthening provisioning requirements. Directors observed that, in the context of a high degree of dollarization, it was all the more important to tighten prudential regulations.

Directors welcomed the reduction in the external current account deficit in 1996. While noting that the deficit had been financed largely by private capital inflows—foreign direct investment for the most part—some Directors nevertheless thought that the size of the current account deficit made the economy vulnerable to external shocks and to changes in market sentiment. Directors emphasized the importance of continuing to increase domestic saving in order to reduce the reliance on foreign saving and to monitor closely developments in exports and capital flows. They considered the present flexible exchange rate policy appropriate.

Directors welcomed the reduction earlier in 1997 of external tariff rates, which helped further improve Peru's external competitiveness through lower import costs. However, they expressed disappointment about the introduction of import surcharges on certain agricultural products, and called for their prompt elimination. To help preserve competitiveness, Directors emphasized the importance of a tight fiscal policy, the pursuit of a prudent wage policy, and further diversification of exports.

Directors encouraged the authorities to persevere in their adjustment efforts and to deepen and broaden structural reforms, including in regard to privatization. They welcomed the measures taken recently to shift certain public services to the private sector and to promote agricultural development.

Directors noted that the successful resolution of external debt issues had improved Peru's medium-term outlook. In that context, they indicated that it was important for the authorities to continue implementing a prudent debt management policy. They commended the authorities for the successful conclusion of bilateral negotiations with Paris Club creditors, and urged them to reach agreement on the few external arrears that remained with nonParis Club creditors.

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

The Executive Board took the following decision:

1. Peru has consulted with the Fund in accordance with paragraph 3(e) of the Extended Arrangement for Peru (EBS/96/95, Sup. 2) and paragraph 4 of the letter dated June 4, 1996 from the Minister of Economy

and Finance and the President of the Central Reserve Bank of Peru, in order to establish performance criteria and the frequency of program reviews during the second year of the arrangement.

2. The letter dated June 5, 1997, and its table, from the Minister of Economy and Finance and the President of the Central Reserve Bank of Peru shall be annexed to the Extended Arrangement, and the letter dated June 4, 1996, with its attached memorandum and table, and the letter dated January 10, 1997 shall be read as supplemented by the letter dated June 5, 1997 and its table.

3. Accordingly,

(i) paragraph 2(a) of the Extended Arrangement is partially amended to read ..".the equivalent of SDR 200.865 million until August 15, 1997, the equivalent of SDR 217.424 million until November 15, 1997, the equivalent of SDR 233.980 million until February 15, 1998, the equivalent of SDR 250.536 million until May 15, 1998, ..."

(ii) through the second year of the Extended Arrangement, the limits, targets, and ceilings referred to in paragraph 3(a) of the arrangement shall be as specified in the table annexed to the letter dated June 7, 1997;

(iii) paragraphs 3(d) and 3(e) of the Extended Arrangement are supplemented as follows:

"(d) after November 14, 1997 until the midterm review of the program supported by this Extended Arrangement, contemplated in paragraph 20 of the attached letter dated June 7, 1997, has been completed; or

(e) after March 15, 1998 until performance criteria for 1998 and the timing of future reviews have been established; or"

4. The Fund decides that the review contemplated in paragraph 3(e) of the Extended Arrangement for Peru has been completed. (EBS/97/102, 6/11/97)

Decision No.11523 -(97/64), adopted
June 25, 1997

4. REPUBLIC OF LITHUANIA—1997 ARTICLE IV CONSULTATION; AND REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff report for the 1997 Article IV consultation with the Republic of Lithuania and the fifth review under the Extended Arrangement (EBS/97/103, 6/12/97; and Sup. 1, 6/23/97). They also had before them a background paper on recent economic developments in the Republic of Lithuania (SM/97/149, 6/13/97).

Ms. Srejber made the following statement:

It has been nearly three months since we last discussed Lithuania in the Board. I am glad to note that this Board discussion will take place on the 4th anniversary of the re-introduction of the Lithuanian currency! More important—despite the relatively short interval since our last meeting on Lithuania, we can bear witness to a number of positive macroeconomic and structural developments. Inflation decreased further to 7.9 percent year-on-year in May; budget revenue collection was higher than projected both in April and May, reflecting the administration's tough actions against tax evasion and delinquent taxpayers, and also the favorable impact of specific measures, such as the introduction of value-added tax invoices, which further improved the overall surplus achieved in the first quarter of 1997. The 28-day T-bill rate dropped below 8 percent for the first time in early June, which authorities associate not only with relatively high liquidity in the financial system, but also with increased confidence from the markets in the authorities' prudent approach to fiscal and monetary policy as well as the stability of the exchange rate. At 5.6 percent, unemployment at the end of May continued to be among the lowest among transition countries. The privatization of major state holdings advanced, with the tender for restructuring and subsequent purchase of Lithuanian Telecom receiving more than a dozen bids, with a pair of companies in each of the communications and airline sectors merged in preparation for the sell-off, and continued efforts by the authorities to let two state-owned banks go private, with a tender for one of them already announced.

A combination of a strong export growth, a stable real exchange rate during the last two years, and competitive wages kept Lithuania's external position on a sound basis. The current account deficit (as a percentage of GDP) is projected to improve slightly this year, and again will be financed almost exclusively—around 90 percent of the capital account—by foreign direct investment and medium- and long-term loans, thus maintaining low exposure of the Lithuanian economy to short-term capital volatility. Lithuania remains one of the least indebted among transition economies, reflecting the authorities' cautious approach to debt management. Furthermore, Lithuania is going to enjoy the benefits of a recently received investment-grade rating. With the opportunities improving, the government intends to tap on capital markets of various currencies in the near future. This is expected to reinforce Lithuania's good credit standing and serve a catalytic role toward enabling the private entities to attract their own foreign financing.

Since the financial turmoil in early 1996, Lithuanian banks have largely followed a rather conservative approach to asset management, which led to considerable strengthening of the banking system. Needless to say, the central bank should be given part of the credit, as it tightened the supervision of the credit institutions and imposed tougher prudential standards. As is already noted in the Letter of Intent of the Lithuanian authorities, the Joint-Stock Innovation Bank, the largest private bank, has been closed recently, after protracted deliberations, and just two weeks ago another bank which had failed to fulfil the prudential requirements of the central bank, had its board removed, the council suspended and its activities limited to a minimum.

Notwithstanding these efforts and the success of the well-performing banks, there are several unresolved issues in the banking sector agenda. As the core of the banking sector is showing a solid and improving performance, it leaves the authorities some room for maneuver in dealing with the troubled banks. At present, three banks, two of them state-owned, do not meet the capital adequacy regulations of the Bank of Lithuania. Since a substantial part of the proceeds from the sale of shares has been already collected, Litimpex, the private bank, has been given an extension till July 1st to complete the issue of new share capital. One of the state-owned banks, the State Commercial Bank, is under official central bank administration, while the share capital of the Agricultural Bank, with a capital adequacy ratio some 0.8 percent too low as of the end of April, will be increased by 33 percent according to a recent decision of the government and the other shareholders; the bank is therefore expected to meet the BOL's capital adequacy requirement shortly. The bank is placed for privatization in the beginning of 1998. In case of the State Commercial Bank, the government is reluctant to use additional budget funds for its recapitalization in a situation where many urgent needs compete for public resources. Thus, in the present situation the authorities consider it more appropriate to privatize the bank in a speedy manner and with the least amount of public outlays. The authorities do recognize that recent legislation which exempted the two state-owned banks from meeting the capital adequacy requirement until they are privatized, is not the most prudent way to deal with bank problems. Bank of Lithuania, together with the government, will, however, enhance its monitoring of the banks' limited activities in the period before privatization. In any event, and as noted above, the Agricultural bank is expected to be capital adequate in the nearest future.

The structural agenda has been given a significant boost by the government, as is shown not only by the recent impetus given to privatization, but also the reforms in the agricultural and energy sectors, and by a number of forceful recent initiatives in the area of governance. The process of harmonization of Lithuania's legal system with that of the EU gained a new impetus from the creation of a legal group in the Ministry of European Affairs, which will largely undertake the responsibilities of adapting the existing Lithuanian legislature to some 1,200 legal acts of the EU. Talks on the accession of Lithuania into the WTO have entered into the stage of bilateral negotiations, and are expected to be completed next year, and privatization of the major enterprises so far has been, and remains, on track. Also, the new Law on Bankruptcy was approved in the Parliament last week, as well as a Law on the Prevention of Money laundering. Furthermore, an anti-corruption law is presently being considered by the legislators.

Finally, I would like, on behalf of my Lithuanian authorities, to thank the staff for their continuous efforts to assist Lithuania in its transformation to a market economy and also for their detailed and candid report.

Mr. Wijnholds and Mr. Botoucharov made the following statement:

Having completed with broad success the first two annual programs under the Extended Arrangement, Lithuania stands at a point of successfully concluding the third-year program with completion of its final review. Indeed, after completing the first phase of stabilization and liberalization by late 1994–early 1995, the successful realization of the medium-term program supported by a three-year Extended Arrangement represents the next step in the authorities' efforts to transform the economy from state ownership and central planning to one based on market principles. Thus, we find ourselves in broad agreement with staff's view that "looking back, the Lithuanian authorities can point with pride to their record of steadfast implementation of adjustment policies."

Lithuania seems to have performed well under the third annual program under the Extended Arrangement. All end-March performance criteria were met with comfortable margins and all prior actions for completion of the fifth review are being basically implemented. The macroeconomic outlook for 1997 remains positive with low inflation and interest rates expected to have a favorable impact on confidence, investments and output recovery. Good progress was made on the structural reform side as well. Thus, after the general elections late last year, the new government initiated a number of actions to reinvigorate the cash privatization program, reform the energy and agricultural sectors, and strengthen the strategy for addressing the weaknesses in the banking sector. In the field of privatization, the government released the names of 14 of the largest SOEs, the telephone company, the national airline and the oil refinery among them, which will be privatized during the period 1997–98 through international tenders. With the aim to speed up the reform of the energy sector, the authorities have increased the electricity and heating tariffs in line with the guidelines on cost recovery pricing. Finally, bearing in mind the importance of the agricultural sector in the national economy, the government is undertaking a fundamental change in domestic agricultural policies aimed at reducing budget subsidies for agriculture, bringing domestic farm prices more in line with international prices and developing the sector's infrastructure.

Notwithstanding these achievements, the need to secure high economic growth on a sustained basis and to complete the restructuring of the real and financial sector would require continued prudent policies and reforms. To this end, the authorities' readiness to continue an active dialogue with the Fund on a broad range of policy issues after the expiration of the present arrangement is welcome. To our mind close collaboration, with or without a new Fund supported program, is even more important in view of the authorities' plan for a gradual evolution of the present monetary arrangement, namely the currency board. Having benefited from the enhanced policy credibility and the limited scope for discretion in financial policies associated with the CBA, the willingness of the Lithuanian authorities to "graduate" from a currency board would require a careful design if they are to avoid undermining the confidence achieved in the last few years. The staff's analysis on the exit strategy and the preconditions for a successful transition gives answers to many questions and concerns. Yet, there does not seem to be a clear answer to the basic question, namely whether the intended exit from the currency board is timely. Here, we would like to recall one of the main conclusions of the recent Executive Board discussion on currency board arrangements, namely that a premature exit would undermine confidence-building and would not allow sufficient time for institution-building, while an overly slow exit might constrain the economy's potential and development over time. We would be interested to hear staff's view on this issue. In addition, we would appreciate if staff could give us some indications about the equilibrium exchange rate and its position vis-à-vis the current exchange rate level, as well as on whether one could expect that the litas will exit from the present monetary arrangement in a position of strength or weakness.

Concerning the exit strategy itself, we find ourselves in agreement with the three-stage program which envisages gradual evolution of the CBA into a traditional currency peg. It seems that both the authorities and staff have worked hard on the program in order to ensure a successful transition. With a view to minimize the credibility loss, the preconditions for successful transition are well analyzed and described in the RED. Yet, we are a bit concerned about the continued weakness of the banking system which could ultimately jeopardize the successful exit of the arrangement. Generally sound banking system and central bank independence, as underlined by staff, should be considered key preconditions for a successful transition. To this end, we are impressed by the authorities' decision to liquidate the largest private bank, Innovation Bank, in a way that avoids fiscal implication in the short term, while the budget will assume only a negligible interest burden over the medium term. More questions remain with respect to the savings restitution plan, but staff's efforts to limit direct budgetary implications of the plan through employing financial resources form privatization receipts only are to be praised.

With these remarks we support the completion of the fifth review under the Extended Arrangement.

Mr. Kiekens made the following statement:

The Lithuanian authorities have shown commendable determination in implementing their stabilization and reform programs in recent years. The gradual acceleration of growth, decline in unemployment, retreat of inflation, and strengthening of the external position all result from their steadfast implementation of adjustment policies. The Fund can take great satisfaction of its part in this successful stabilization effort, which lays the foundation for further beneficial collaboration between the Fund and the Lithuanian authorities.

But despite these achievements on the stabilization and structural fronts, Lithuania still faces several difficult challenges. Chief among these is the task of creating conditions for rapid and sustainable growth. The staff rightly points out that Lithuania's economy is presently growing too slowly to reach, within a reasonable time, an income level comparable with those of Western Europe. We therefore applaud the authorities' target of achieving an annual real GDP growth rate of 7–8 percent in the medium term. To succeed, however, they will have to increase private savings by much more than the targeted overall increase of 1.7 percentage points of GDP for the next six years, or else attract much larger amounts of foreign direct investment. I note, however, that the staff has predicted that total savings will increase by 5 percent during the next six years, mostly from public savings realized through further fiscal consolidation. Fiscal retrenchment will thus make room for the private sector to develop faster.

An obvious way of stimulating growth in the longer term is to reduce inflation. We therefore think that the target of reducing inflation by one percentage point per year should be regarded as a minimum acceptable achievement. Some Directors recently criticized the Czech authorities for putting the reduction of inflation to Western European levels second to considerations of growth and employment. I hope the Lithuanian authorities do not believe that somewhat higher inflation may lead to higher growth.

The authorities argued that the higher-than-average inflation in the nontradable goods sector will cause higher inflation in Lithuania than it does in western Europe. I can agree with this view. Indeed, in the period ahead, wages in transition countries like Lithuania will have to rise substantially to attain levels approaching Western European salaries. In the traded goods sector, those wage increases will not rekindle inflation provided they are matched by productivity increases. However, it is generally accepted that those wage increases in the traded goods sector will be largely paralleled by wage increases in the nontradable goods and services sectors, where there is less room for matching productivity gains. This will therefore result in somewhat higher inflation in the transition countries. The staff's projects that inflation in Lithuania will gradually decline from 11 percent this year to 6 percent in 2001. These levels are 3 percent to 8 percent higher than projected for Western Europe. I wonder whether the staff can estimate the extent to which this differential is due to the inflation bias from the nontradable goods and services sectors.

Some remarks on the fiscal side. I welcome the staff's assessment that the 1997 fiscal program is on track. However, I note a revenue shortfall for this year of about 0.2 percent of GDP which gave rise to a spending reduction of a similar size. Commendable as this corrective action may be, I think the authorities should focus more on increasing revenues so that they can make badly needed public infrastructure investments. Public investments fell from 3.2 percent of GDP to barely 2 percent. This is a very low level, given the deterioration of the public infrastructure and the huge investment needs of transition economies.

For this reason, we welcome recent increases in excise taxes, as well as the authorities' intention to adopt additional revenue measures if the second quarter budget performance falls short. I wonder what measures besides further excise increases the authorities may be considering, since other transition countries have found that increasing excise rates does not always produce a net increase in revenues.

We support the proposed decision and wish the authorities all the best.

Mr. Vernikov made the following statement:

I had hesitated to ask for a lead speaker position, because there is not much to add to the staff's excellent report. I share practically all of the staff's findings and recommendations. Indeed, Lithuania has been a very good performer. Even on the structural front, where reforms have tended to lag behind in other transition economies, there was quite substantial progress.

I very much welcome the reduction of inflation to single-digit levels. Lithuania's ability to achieve that shows that the argument of presumably high stubbornness of inflation at about 20 percent may be overstated. Very low inflation has contributed to increased credibility of market participants and to bring interest rates down further.

May I ask two specific questions. First, I wonder how the staff would assess the degree of development and sophistication of the government debt market in Lithuania? And what are the major features of the authorities' strategy in terms of instruments, currency denomination, etc? Second, looking at Figure 1 on page 5, I am curious as to why the pattern of net capital inflows has been so uneven. What are the reasons behind that volatility and seasonality. The answer could be instructive to other transition economies?

The authorities' structural agenda is impressive and commendable. The efforts to strengthen the banking sector and increase its transparency are timely and relevant, even if the problem of adequate capitalization of banks is not an issue that can be addressed in a speedy fashion. It is quite noteworthy that the authorities try to withstand and overcome the pressures of protectionism by dismantling some of the restrictions still hampering free foreign trade, especially in agriculture. Liberal free trade, and not only within a given economic grouping, is indispensable for an economy poorly endowed with natural resources unless it wants to embark on a costly path of import substitution.

Finally, I must confess that the more I learn about the achievements of the Lithuanian authorities and their current agenda, the less I understand the rationale for departing from the currency board arrangement. The staff has noted that in real terms the litas has not appreciated excessively over the past several years. The level of dollar wages is among the lowest in the region. The inflation differential is unlikely to play a big role in the real appreciation of the currency in the period ahead in view of the single-digit inflation objective. I fail to see what the benefits are that the authorities expect to reap through abandonment of the CBA and greater flexibility of monetary policies.

Apart from the philosophical question of the need to depart from the CBA, there is also the question of timing, and on this I would echo the question in the statement by Messrs. Wijnholds and Botoucharov.

With these remarks, I would like to support the proposed decision and wish the Lithuanian authorities further success.

Mr. Costa made the following statement:

Let me start by congratulating the Lithuanian authorities for the impressive progress made since its independence a few years ago. After reverting the initial sharp decline of real output Lithuania is now on a clear path of sustained expansion, implementing a program of widespread structural reforms and preparing for full integration with Europe. The authorities seem to know what needs to be done to raise the standard of living of the population and what is most important they seem to have sufficient political support to undertake the remaining reforms.

Staff points out that in order to achieve convergence with European standards, the rate of growth of the economy should be substantially higher than at present. That would require a more accelerated rate of capital accumulation, that includes foreign direct investment as well as public investment channeled toward basic infrastructure projects. Notwithstanding the critical contribution of foreign direct investment in terms of managerial and technological know-how transfers, and the improved access to foreign markets that it usually entails, the authorities should not downplay the importance of strengthening national saving so as to privilege the sustainability of the development process. It is of some concern that in spite of the relatively low levels of investment the current account deficit already exceeds 4 percentage points of GDP.

Given the need to improve investment in infrastructure it is not clear if private sector participation modalities used in other countries are also being considered in the case of Lithuania. If, on the other hand, public investment is the road chosen, it seems unavoidable that the Lithuanian authorities should strengthen their efforts to raise the overall revenue level. As staff points out, besides infrastructure investment there are other pressing budgetary needs, particularly that of raising public wages to a more competitive level vis-à-vis the private sector to ensure an efficient public administration.

To raise revenue as a percentage of GDP care should be taken not to rely excessively on high rates of taxation, which appears to be the case with social security contributions. Estimates presented by staff suggest substantial scope for broadening the tax base and reducing evasion given the extent of under reporting and underground activities. Intensified efforts are called for winding down arrears. More drastic measures than those announced in the paper seem necessary for their normalization, particularly of those accumulated in the areas of social security and energy sector . In fact, short of complete privatization of those services the prospects of resolving the arrears problem in the energy sector seem poor. Another source of concern relates to the absence of reliable estimates of the budgetary costs of the 1995 financial crisis and the potential for mounting costs in this area. Some clarification from staff as to the amounts involved would be appreciated. Efforts in revenue collection are critical not only to meet basic developmental and social needs, but also to impart on the population a sense of shared responsibility while fostering greater accountability on the part of the authorities. The early concern that is being shown with matters of governance is a welcome development that strengthens credibility and consequently serves to reduce the country risk premium.

Regarding monetary policy, the Currency Board Arrangement in place since 1994 provided a credible stabilization framework which not only was conducive to a steep decline of inflation but also allowed Lithuania to weather a major crisis in the banking system without the need to change its exchange rate or, as importantly, abandoning its inflationary objective. The often voiced weakness that CBA does not provide for a lender of last resort function proved to be inconsequential in the case of Lithuania. The question that is insufficiently answered, in our view, is why the Lithuanian authorities felt it advantageous to abandon the CBA and move to a conventional peg at this time. The answer seems to lie merely in the fact that a conventional peg facilitates the introduction of a more flexible range of monetary policy instruments, thus enabling the central bank to influence monetary aggregates and to implement more active monetary policy.

To the extent that there exist an agenda for full Lithuanian access to the European Union this move would seem justified. Since this is far from being the case, my impression is that Lithuania has introduced an unnecessary degree of risk by abandoning the fixed monetary rule under the CBA. Unnecessary because, as it was fully documented in our seminar on CBA- Issues, Experiences, and Implications for Fund-Supported Programs in January of this year, the CBA can be adapted to allow for some degree of monetary sophistication in particular through OMOs aimed at smoothing out short-run interest rates volatility without the need to relinquish the basic commitment of fully backing the monetary base. In the second place, because in order to maintain the credibility of the conventional peg the Lithuanian authorities have imposed on themselves strict limits to the capacity of the central bank to extend credit even to bring the balance of the BoL's repurchase operations periodically to zero as it is stated in Parag. No.7 of the MEP. Thus, the new arrangement continues to resemble in operation that of a CBA.

The conclusion is that the authorities will be operating a scheme that could have been accommodated within a CB framework, yet by abandoning the CBA they will lose the additional degree of predictability provided by a CBA which will be reflected in the exchange rate risk premium of the interest rates. In this regard, it is worth recalling the conclusions derived in the context of the last World Economic Outlook, when it was explicitly recognized that in the present world of globalized financial markets, conventional pegs are increasingly vulnerable and that a more unambiguous commitment to a given fixed rate is necessary, such as those embodied in a CBA. Staff comments would be appreciated.

Finally, I have found the linkage between the restitution of savings to depositors in state-controlled banks at the time of Independence and the pace of collection of privatization proceeds a very good incentive mechanism to deepen the privatization process. I share staff concerns, however, regarding the macroeconomic impact on consumer spending and the balance of payments of such a scheme and agree with the need for a close monitoring.

Mr. Loevinger made the following statement:

Given, first, that we are in broad agreement with staff's recommendations and, second, that this chair's views on key issues such exchange rate, monetary, and trade policy have not changed from the extensive remarks we made just 3 months ago, I will limit comments to a few additional remarks. However, given the remarks of other Directors today I want to reiterate what we said at the last review about the authorities' plans for exchange rate policy. We believe the three-stage plan to shift from the currency board arrangement to a traditional currency peg is a sound approach. The exit strategy appears carefully designed to preserve confidence in the currency, and importantly it seems both transparent and orderly.

We commend the authorities and staff for the excellent job they are doing. In fact, given the busy board schedule this would have been a good case for the lapse of time procedures.

In fact, because the economy is doing so well, I do not see much of a balance of payments need for further purchases. Given Lithuania's investment grade status, it would appear that it could access international capital markets at favorable terms. I wonder whether there has there been any consideration of foregoing the remaining purchases.

I will make two points about the authorities' policies. First, we agree with staff on need to limit commitments to depositors through the Savings Restitution Plan. While I understand there was a political commitment to provide some kind of restitution, it is not clear that the proposed plan is the most growth or welfare enhancing use of scarce public resources.

Second, we urge the authorities to go further in raising the retirement age for public pensions. It is commendable that one of the key goals is to achieve a Western European standard of living. But that will bring Western European health care, Western European life expectancies, and unless the retirement age is sufficiently high and benefits are limited, Western European fiscal problems. We hope the authorities are able to achieve the first two and avoid the last.

Finally, it is good to see that the authorities intend to actively collaborate with the Fund at the expiration of this arrangement. However, given the importance of maintaining confidence during the transition to a more flexible exchange rate arrangement, it seems to me that it would be useful, and important, that this collaboration take place within some kind of formal mechanism, such as a precautionary arrangement or strengthened surveillance.

Mr. Gruber made the following statement:

We agree with the thrust of the staff appraisal and, therefore, confine ourselves to a few short remarks.

We are satisfied to see that the economy of Lithuania is growing, that unemployment is falling, and that stabilization has been achieved. As all end-March 1997 performance criteria were met, and structural reforms were broadly on target, we approve the staff's proposed decision to complete the fifth review. However, it is regrettable that the end-March 1997 structural benchmark on consumer indebtedness for energy was not met, and the fact that most of the increase in indebtedness was accounted for by budgetary organizations would seem to be particularly detrimental to the credibility of the authorities' policies in this particular sector.

On the banking sector, the authorities' letter provided in the appendix states that banks that are currently state controlled will be made capital adequate, either by privatization with adequate outside capital or by the transfer of nonperforming loans to the asset management company and recapitalization with government securities, followed in due course by privatization. However, this latter option would not resolve the problem of mismanagement, which the staff's report tells us that the authorities perceive as being responsible for the banking crisis in the first place. If privatization with adequate outside capital does not materialize, as the staff fears it won't, the government might consider using management contracts for a transition period in order to get the incentives right. In any case, it would appear reasonable that proper management of the banks should be ensured before injecting new capital into them.

As experience in other transition countries showed, a clear statement of the ultimate objective, organizational restructuring, improvement of the management capacities (for instance by long-term technical assistance contracts with reputable foreign banks) and a thorough audit by international auditing firms are essential prerequisites for the success of bank recapitalization and privatization. The recapitalization can only be successful in sustainably restoring capital adequacy, if it is accompanied by the implementation of a framework giving the right incentives to the management, and if it is preceded by a comprehensive reorganization of banks' management structures. The exemption of state-controlled banks from capital adequacy requirements goes thereby in the wrong direction. We support the staff's recommendation to the government and the Bank of Lithuania to spell out more clearly the overall strategy for restoring banking soundness and to implement it consistently.

Concerning the sustainability of fiscal policy, we note that after the cut in capital expenditure in 1996, spending in this vital area is programmed to be kept at this lower level and even to fall slightly further in 1997. This is regrettable as significant capital expenditure is still necessary to ensure that Lithuania's economy is provided with adequate infrastructures. We would therefore like to encourage the authorities to increase capital expenditures in the subsequent years by shifting the composition of spending away from subsidies and sectoral lending toward infrastructure as is foreseen under the program, and not to allow any short-term considerations which may arise in the meantime to obstruct the long-term perspective.

The exit from the currency board arrangement certainly has to be designed carefully to avoid undermining of policy credibility which has been built up during the CBA. The reaction of market participants on speculations on a possible abrupt abandonment of the CBA showed clearly how important the design of a transparent strategy and strict adherence to the announced plan is. We consider the envisaged three-stage-program as appropriate to secure a smooth shift to a traditional currency peg. As outlined in the RED, the implementation of the program has, however, to be accompanied by a number of structural reform measures to minimize the credibility loss and to ensure a successful transition. The question if the intended exit from the currency board will be timely will therefore strongly depend on the progress in these structural reforms. We agree with Mr. Wijnholds and Botoucharov that close collaboration with the Fund is important during this delicate phase of transition to a conventional peg.

Mr. Kiekens observed that Mr. Loevinger had remarked that Lithuania would have much to gain from continued close cooperation with the Fund. In his own understanding, a further annual arrangement under the Extended Fund Facility would provide the authorities with necessary support to continue disciplined structural, monetary, and fiscal policies, and would enhance the credibility of their policies in international markets.

The question had also been raised whether a further arrangement should be a precautionary one, rather than a standard one under which Lithuania could draw financing in light of a balance of payments need, Mr. Kiekens continued. On the one hand, the staff had projected not insignificant external current account deficits of about 4 percent of GDP; on the other hand, Lithuania's debt was investment grade debt, meaning that the country had sufficient access to international capital markets. He wondered whether the staff had discussed with the authorities the possibility of a follow-up program and whether it should be a standard or precautionary program. Furthermore, he wondered how the Fund assessed the balance of payments need of a country that had access to international capital markets. That being said, he recognized that there was a trade-off between the least costly financing, presumably from the Fund, and somewhat more costly financing from markets—which was the case even if a country had a good credit rating.

The staff representative from the European II Department commented that program for 1997 was for the third and final year of the Extended Arrangement. While the staff had discussed various options with the authorities on further cooperation in 1998, the government and the Bank of Lithuania would inform the staff of their intentions once it had come to a decision.

The substantial decline in inflation in 1996 had been impressive, and had been due primarily to the excellent supply response of the economy, particularly that of agriculture, the staff representative continued. The different productivity growth rates in the traded and nontraded goods sectors over the medium term were just one of the sources of inflation. Other sources included the impact of administrative price adjustments—on housing, for example, on which prices were low by international standards—and the ongoing process of inflation convergence between Lithuanian prices and world market prices, including for traded goods. The projected difference between Lithuanian and western European inflation rates over the medium term would owe primarily to the preceding factors, although it was not possible to estimate the relative weights of each of those factors.

The shortfall in the revenue projections was simply relative to the staff's earlier projections, which were less accurate than the current ones; current projections included the effect of the excise taxation package and reflected the revenue figures from the first few months of the current year, the staff representative explained. The improvement in the fiscal outlook based on increased revenue collection from excise taxes was sustainable. Before the excise tax increases, the rates on petroleum, cigarettes, and alcoholic beverages had been low, with the result that the increased rates had generated significant new revenues that were likely to persist. The authorities were far from being in a situation in which higher excise tax rates might result in lower revenues.

When the banking system had been under stress at the start of 1996, the staff had worked closely with the authorities and the World Bank on means of addressing the problem, the staff representative remarked. The estimated cost of bringing the balance sheet of the banking system to capital adequacy was 2–3 percent of GDP. In flow terms, if the system were recapitalized, the cost would be equivalent to interest payments on the amount equivalent to 2–3 percent of GDP. Given that some banks had since been liquidated and various forms of compensation for depositors had been instituted, the current cost of recapitalizing the banking system would likely be significantly lower than the original calculation had indicated.

The market for domestic debt instruments was not highly developed, and much more needed to be done, the staff representative pointed out. The government was offering a greater range of maturities on government debt, moving beyond its heavy reliance on 1-month and 3-month maturities to 6-month and 12-month maturities, which had been well received by the market. The government was also improving the functioning of the secondary debt market, including by eliminating differential taxation, which had affected the development of that market.

Consumer indebtedness and arrears in the energy sector could be dealt with substantially without full-scale privatization of that sector, the staff representative confirmed. The authorities were taking measures to that end and had assured the staff that they would meet the end-June benchmark on consumer indebtedness. One of the reasons for the lack of payments discipline in the energy sector had been the behavior of budgetary organizations; often, those organizations' arrears had not been due to lack of financial resources, but to their choice to use budgetary allocations for purposes other than making energy payments, such as for paying higher wages. In doing so, the budgetary organizations had recognized that, given their own important governmental functions, it would be difficult for energy companies to stop supplying them because of their arrears. Regarding a similar situation with local governments, the authorities had adopted a simple system of paying the energy company directly from the finance ministry in the event that such governments accumulated arrears. Likewise, the authorities were moving forcefully to improve the payments discipline of budgetary organizations.

With their three-stage strategy for exiting from the currency board, the authorities were essentially trying to have a tight framework for fiscal and monetary policy and some additional flexibility beyond what was usually possible under a currency board, the staff representative stated. Deliberately, the first stage in the strategy involved only a small move away from the currency board, in order not to surprise any market participants about the policy intentions of the Bank of Lithuania. Each step in the exit strategy would be small, in order to have minimal effects on the market. In fact, the Governor of the Bank of Lithuania had stated that the best means of exiting from a currency board would be one that enabled the authorities to announce that the exit had taken place a year previously, without anyone having noticed the exit at that time.

The volatility of capital inflows under the currency board indicated in Figure 1 of the staff report was a classic illustration of the effects of policy uncertainty on market participants, the staff representative added. The three significant episodes of capital outflows coincided with expressions of doubt in the currency board by senior officials of the Bank of Lithuania; the eruption of the banking crisis; and the election victories of a political party that had made a shift away from the currency board part of its election platform. Each of those events had been associated with substantial capital outflows, and subsequent reflows/inflows when uncertainty had subsided.

Mr. Costa wondered about the quality of assets in the banking system, which were equally important to the soundness of the system as minimum capital requirements. Furthermore, beyond what was said in the staff report already, he wondered how Lithuania would benefit from exiting the currency board.

The staff representative from the European II Department responded that, in estimating with the authorities the cost of recapitalizing the banking system, they had taken into account the quality of bank assets. By writing down lower-quality assets, the capital adequacy of banks could decline, though one had to take into account the fact that the quality of assets changed over time. The staff's estimates had taken into account the large problems with the quality of assets in the balance sheets of banks.

Regarding the currency board, he would reiterate the basic argument in the staff report, the staff representative said. The authorities believed that they would benefit from the extra degree of flexibility offered by a pegged exchange rate regime, and did not believed that they would lose much in the process, given their incremental transition plan that would entail no credibility losses. In its discussions with the government and the Bank of Lithuania, the staff's position had been that it was for the authorities to decide which type of regime they preferred. The important point was that, at each stage of the planned exit from the currency board, the necessary preconditions for the exit had been met, including a significant strengthening of the soundness of the banking system.

Mr. Vernikov asked if there had been any indication on how the authorities intended to use the additional flexibility afforded by an exit from the currency board arrangement, which was why a few Directors had doubted the rationale for the exit.

The staff representative from the European II Department remarked that the authorities wished to have as many economic policy instruments at their disposal as possible, even if they did not have immediate plans to use all of them. In the future, they saw Lithuania as being part of an integrated European monetary system, and believed that the European central bank would conduct its operations throughout Europe, including perhaps the money and foreign exchange markets in Vilnius as well.

The staff representative from the Policy Development and Review Department commented that, given the recent Board discussion on Lithuania (EBM/97/31, 3/31/97), it would have been possible—albeit unusual—to have held the Article IV consultation on a lapse-of-time basis. Generally, the staff had proposed concluding Article IV consultations on a lapse-of-time basis only sparingly.

Mr. Loevinger noted that Lithuania was a strong performer, and that the Board had discussed the country only three months' previously, and had issued guidelines recently on the conclusion of Article IV consultations on lapse-of-time bases. If not Lithuania, it was hard to think of a case that would be more appropriate for lapse-of-time consideration of an Article IV consultation.

The Acting Chairman recalled that the Managing Director had indicated that Article IV consultations should be considered on a lapse-of-time basis only rarely. In Lithuania's case, no Executive Director had suggested lapse-of-time consideration of the consultation. The current discussion had, in any event, been especially useful in elaborating Directors' various positions on the currency board arrangement.

Mr. Loevinger added that the other advantage of lapse-of-time consideration was that it would lighten the Board's schedule, which was heavy in the current week.

The Acting Chairman commented that that point was well taken, but that in the specific case of Lithuania there was merit in holding a Board discussion.

The staff representative from the Policy Development and Review Department said that there were typically three factors identifying a balance of payments need: an overall balance of payments deficit (which the Fund was not projecting for Lithuania in 1997); a low level of reserves; and prospective balance of payments developments. Lithuania had relatively low reserves, which the staff was projecting would be equivalent to 2.3 months' of imports in 1997. While it was a matter of judgment what a low level of reserves was, the staff had considered that, in Lithuania's case, it should err on the side of caution given the potential for substantial volatility in capital flows, as the staff representative from the European II Department had noted. The staff's assessment of the extent of the balance of payments need would be one of the factors that influenced the Fund's consideration on whether Lithuania might benefit from a precautionary arrangement.

Mr. Loevinger observed that the medium-term balance of payments scenario indicated that the staff had not planned on Lithuania accumulating more reserves than 2.3 months' of imports. If that level of import coverage was considered low, he wondered whether or not some more concern was warranted about the medium-term balance of payments outlook.

The staff representative from the European II Department commented that the staff would have to consider the level of reserves more carefully as the situation evolved. While the reserves projections were somewhat uncertain, they were based on the current level of reserves. Reserves had fallen as a ratio of imports since 1996 because the staff had, for statistical reasons, increased its estimate of trade flows. While the staff hoped to hold further discussions with the authorities on the preferred level of reserves, it would be imprudent for Lithuania to hold less reserves than the projected 2.3 months' of imports.

Mr. Loevinger wondered whether, under a currency board, the ratio of gross reserves to outstanding local currency liabilities was also relevant to judging the adequacy of reserves.

The staff representative from the European II Department commented that, under a currency board, the only means by which a central bank could increase its reserves coverage was through increased profits, which could not be projected with confidence. In its medium-term scenarios, the staff, in any event, was not projecting a continuation of the currency board arrangement. It did not believe that reserves were too low, but simply that they were not high enough to call into question the balance of payments need necessary for Lithuania to make purchases under the existing Extended Arrangement.

The staff representative from the Policy Development and Review Department added that the staff's reserves projection took into account purchases by Lithuania under the Extended Arrangement, otherwise reserves would be lower than projected. Furthermore, over the medium term, any judgment regarding the adequacy of reserves depended, to some degree, on the type of exchange rate system in place, how long it had been in operation, and the authorities' policy record. Among the Baltic countries which had currency boards or fixed exchange rate regimes, there had been some uncertainty about what the minimum or adequate level of reserves should be. In those circumstances, the staff had consistently erred on the side of caution, favoring a higher rather than lower level of reserves. As Lithuania's policy record had lengthened and strengthened further, the level of reserves with which one could feel comfortable would change accordingly. The staff had been cautious in judging the adequacy of reserves given the severe capital outflows as recently as a year previously. While Lithuania's reserves were not so high as to call into question the country's balance of payments need, with the passage of time, the staff could begin to question seriously whether the need was sufficient to warrant continued purchases from the Fund.

Mr. Loevinger asked what difference it would make to the reserves projection if Lithuania did not make the last two purchases available under the Extended Arrangement.

The staff representative from the European II Department said that the difference would be within a decimal point of the current projections.

Mr. Costa stated, for the record, that increased profits were not the only means through which a central bank could increase its coverage of the monetary base under a currency board. In Argentina, the central bank had credit lines with international commercial banks—amounting to 10 percent of total monetary liabilities—which could be activated in the event of a crisis in the financial system. Furthermore, as had been indicated at the Board seminar on currency board arrangements (EBS/97/1, 1/24/97), authorities did not need to exit a currency board in order to have a full-fledged central bank.

Ms. Srejber made the following concluding statement:

> Let me first thank all of you for your attention and participation in the discussion. The staff, as usual, was truly helpful in answering all the questions and commenting on the issues raised today. I have very little to add, actually. There are only two issues I would like to comment on further. One is the issue about why Lithuania has chosen to very, very gradually leave the currency board arrangement. That has been extensively discussed again today. he other is the future form of cooperation between the Fund and Lithuania.

Starting with the exit from the currency board, I think it is necessary to remember that the currency board arrangement in Lithuania was never meant to be for eternity. The Lithuanian authorities feel that it is normal to have a full-fledged central bank. As touched upon by the staff representative from the European II Department, the Lithuanian authorities feel that, in their efforts to move closer to the European Union and also, in the future, to the EMU, it is the best way forward for them to have a central bank with all normal policy instruments available. That does not mean that they have any secret plans about using the exchange rate in one way or the other.

As concerns future cooperation with the Fund, a topic raised by many Directors now when there is less than four months left before the present Fund arrangement expires, my Lithuanian authorities think it is completely clear that the present and also earlier programs, despite certain hardships throughout the implementation, are bearing ripe fruit in terms of good economic performance and a stable external and fiscal and macroeconomic situation in general, which sets a good stage for second generation reforms.

My Lithuanian authorities are still contemplating what exact form of cooperation they would like to embark on, but for those of you who have had concerns about whether Lithuania would like to continue to borrow from the Fund, although Lithuania can raise resources in the money and capital markets, I can assure you that my Lithuanian authorities do not have any plans to continue to use Fund resources. After this present arrangement, if they embark on a formal program, it would be of a precautionary type. But, as I said, they have still not made up their minds. They feel that there is still time to think about it, as there is still four months left.

That is all I would like to add to staff's comprehensive answers.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended Lithuania for the considerable progress made in reducing inflation and in attaining strong growth. Directors noted that, over the period of the program supported by the Extended Arrangement, a stable macroeconomic framework had emerged, outward-oriented trade policy had been pursued, and budgetary management had been improved significantly. Directors nonetheless stressed that, in the period ahead, to enhance prospects for more rapid and sustained growth, further efforts would be needed to increase domestic savings, speedily resolve problems in the banking system, and deepen structural reforms, particularly in the areas of privatization, agriculture, and social security provision.

Directors noted that significant progress had been made in fiscal adjustment and reform. They observed that the authorities had taken timely action to address the risks of slippages in 1996 by improving tax administration and by introducing measures to increase revenues, notably under the value-added tax and excises. Directors emphasized the need for continued vigilance, and took note of the authorities' readiness to take further revenue-raising measures if circumstances required. In that context, they suggested further efforts be made to broaden the tax base and to address tax evasion. They also called for full implementation of the treasury system and further enhancement of tax and customs administration. Directors expressed concern about delays in payments by the Social Insurance Fund and underscored the need for speedy reforms of the financing of that Fund, including its indexation rules and the retirement age. They also encouraged the authorities to improve the composition of expenditures, by giving greater priority to public investment.

A few Directors considered that the medium-term exchange rate strategy announced by the Bank of Lithuania was appropriate, against a background of the authorities' desire to develop increased central bank functions. A few other Directors, however, wondered about the wisdom of moving away from the currency board arrangement, which had served as a key element in achieving financial stabilization. They pointed out that the currency board arrangement had provided a credible monetary rule and that it could be adapted to deal with increasing financial sophistication. Directors stressed the importance of ensuring a timely exit from the currency board arrangement, so as to maintain the confidence of market participants while safeguarding central bank independence and its lender of last resort function. Directors emphasized that establishing a sound banking system and central bank independence were key preconditions to a successful transition.

Directors agreed that the completion of banking system restructuring remained an urgent task. They regretted that the overall strategy for restoring financial soundness to the banking system has been neither fully articulated nor pursued consistently. Directors commended the Bank of Lithuania for its actions in dealing with private banks that had failed to meet prudential regulations; they urged the government to bring state-owned banks to prudential compliance as a matter of the highest priority and to ensure that, in the meantime, those banks were not a source of instability in the banking system. Directors expressed their concern about the possible macroeconomic impact of the Saving Restitution Plan, and called on the government to enforce strictly all of the limits designed to minimize threats of instability, and to limit the Plan's fiscal costs.

While significant progress in the area of structural reform had been made, Directors underlined the need for further efforts in order to accelerate growth. They considered the establishment of the Energy Pricing Commission an important step forward, and also commended the authorities' efforts to regularize the financing of the energy sector through the reduction of arrears. Directors encouraged the authorities to take a bolder approach to sales of state holdings, particularly in the energy and transport sectors. As regards agriculture, while welcoming the recent measures to eliminate distortions in that area involving more efficient targeting of budgetary support, Directors encouraged more efficient use of resources.

Directors welcomed the authorities' readiness to continue an active dialogue with the Fund after the completion of the present arrangement. The possibility of another arrangement was suggested. Directors encouraged the authorities to consult closely with the staff, particularly in the context of the evolution of the currency board arrangement.

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

Mr. Botoucharov, noting that the Acting Chairman had remarked in his summing up that a few Directors had doubted the wisdom of moving away from the currency board arrangement, commented that it would be preferable if the Board was not be seen a doubting the exit strategy. Instead, a few Directors had simply asked several questions about the strategy. If the authorities were to request the issuance of a press information notice, the expression of doubts on the part of Directors might prompt a negative market reaction.

The Acting Chairman asked Ms. Srejber for her a view on the matter.

Ms. Srejber said that she, and the Lithuanian authorities, considered that summings up should be as accurate and as direct as possible. Regarding press information notices, the Executive Board had agreed that market-sensitive information should be deleted, which meant that the Board would not be prevented from being tough or skeptical in its summings up, if it so desired.

The Acting Chairman stated that he agreed with Ms. Srejber; the issue of whether or not to issue a press information notice should not affect the content of summings up.

The Executive Board took the following decision:

1. The Republic of Lithuania has consulted with the Fund in accordance with paragraph 3(d) of the Extended Arrangement for the Republic of Lithuania (EBS/94/199, Sup. 2, 10/27/94), as amended, and paragraph 25 of the letter from the Prime Minister and the Governor of the Bank of Lithuania dated March 8, 1997, in order to review developments in the implementation of the policies and measures adopted under the program supported by the Extended Arrangement.

2. The letter from the Prime Minister and the Governor of the Bank of Lithuania dated June 12, 1997 shall be attached to the Extended Arrangement for the Republic of Lithuania, as amended.

3. The Fund decides that the review contemplated in paragraph 3(d) of the Extended Arrangement for the Republic of Lithuania, as amended, is completed. (EBS/97/103, 9/12/97; EBS/97/103, Sup. 1, 6/23/97)

Decision No. 11524-(97/64), adopted
June 25, 1997

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/63 (6/23/97) and EBM/97/64 (6/25/97).

5. GROUP TRAVEL BY EXECUTIVE DIRECTORS—GUIDELINES

The Executive Board approves the guidelines for a group travel program as set forth in EBAM/97/98 (6/13/97).

Adopted June 23, 1997

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/101 (6/20/97) is approved.

APPROVAL: November 21, 1997

REINHARD H. MUNZBERG
Secretary