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December 23, 1996

To: Members of the Executive Board

From: The Secretary

Subject: **Modalities for Special ESAF Operations in the Context of the HIPC Initiative and Other ESAF Issues**

Attached for consideration by the Executive Directors is a paper on modalities for special ESAF operations in the context of the HIPC initiative and other ESAF issues, which is proposed to be brought to the agenda for discussion on Wednesday, January 22, 1997. A summary appears on page 18.

Ms. Christensen (ext. 38397), Mr. Dhruba Gupta (ext. 38321), or Mr. Morais (ext. 37788) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Modalities for Special ESAF Operations in the Context of the HIPC Initiative and Other ESAF Issues

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I. INTRODUCTION

At their September 1996 meetings, the Interim and Development Committees warmly endorsed the Program of Action proposed by the Managing Director of the Fund and the President of the Bank to ensure that the Heavily Indebted Poor Countries (HIPCs) that have established a sound track record of economic adjustment can attain a sustainable debt situation over the medium term. The Interim Committee endorsed the conclusions of the Executive Board on financing the continuation of ESAF and the Fund's participation in the Initiative to assist the HIPCs. The Interim and Development Committees requested the Executive Board to proceed quickly with implementation and to report on progress at their meetings in Spring 1997.[1]

During the September discussions,[2] the Executive Board agreed that the Fund's participation in the HIPC Initiative would be through special ESAF operations that would take the form of a reduction in the net present value of the debt owed by a country to the Fund through the provision of grants or loans on extended maturities, to be used solely for paying debt service falling due to the Fund. The Board was prepared that until new resources to finance a continuation of the ESAF and the Fund's participation in the HIPC Initiative were available, special ESAF operations under the HIPC Initiative would be financed from an early transfer of resources from the ESAF Trust Reserve Account to the Special Disbursement Account (SDA). The Managing Director, in his Summing Up of the September 18 Board meeting, welcomed the indications of ESAF creditors to accept a possible modest reduction in the reserve coverage of outstanding ESAF Trust obligations that would be implied by an early transfer from the Reserve Account. The Interim Committee welcomed the agreement on the transfer.[3]

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[1]*Communiqué of the Interim Committee of the Board of Governors of the IMF*, September 29, 1996, Press Release No. 96/49; and *Communiqué of the Development Committee, Joint Ministerial Committee of the Board of Governors of the Bank and the Fund*, September 30, 1996.

[2]See *Financing a Continuation of the ESAF and the Fund's Participation in the HIPC Initiative*, EBS/96/133 (8/23/96); *The HIPC Debt Initiative—Elaboration of Key Features and Proposed Procedures*, EBS/96/135 (8/26/96); *Summing Up by the Chairman, Financing a Continuation of the ESAF and the Fund's Participation in the HIPC Initiative and Elaboration of Key Features and Proposed Procedures for the HIPC Initiative*, BUFF/96/110 (9/19/96); and *The HIPC Debt Initiative, A Program of Action. Report of the President of the World Bank and the Managing Director of the IMF*, EBS/96/152, Revision 1 (9/20/96).

[3]The Communiqué of the Interim Committee mentioned that "It also welcomed the agreement to transfer a portion of the ESAF Reserves to support the Fund's participation in the HIPC Initiative with grants or loans on longer maturities."

This paper proposes the operational and financing modalities of an ESAF-HIPC Trust for special ESAF operations. The Trust would receive bilateral contributions and transfers from the SDA for both the continued financing of the ESAF during the interim period 2000/01-04 and the Fund's participation in the HIPC Initiative. It should be seen in the context of a set of intertwined ESAF-related issues, which have been, or will be, described in separate papers:

- The extension by four years of the commitment period for ESAF loans from December 31, 1996 to December 31, 2000, to allow the full commitment of current ESAF resources;[4] the necessary modification of the ESAF Trust Instrument was approved on a lapse-of-time basis on December 9, 1996, and the approval by the ESAF lenders is now being sought.[5]

- The modalities for refunding SCA-2 balances to contributors, and their possible use to generate resources for the ESAF.

- Progress on financing the continuation of ESAF, through bilateral contributions, and, if needed, the optimization of the management of the Fund's reserves.

- The internal and external reviews of ESAF-supported programs will, inter alia, serve as a basis for a discussion of a strengthening of conditionality of ESAF arrangements.

At a later stage, the modalities for interim ESAF operations during 2000/01-04 and for self-sustained ESAF operations thereafter will be established. These are all essential elements of the continuation of ESAF operations. However, they will need to be addressed in sequence. There is a particular urgency now to establish a new Trust for special ESAF operations under the HIPC Initiative in view of the possibility that a few countries could reach their decision points—and be judged to require assistance under the HIPC Initiative—in early 1997, in which case the Fund would have to be in a position to commit its resources as a participant in the Initiative. The Trust would also receive subsidy contributions for interim ESAF operations. The requirement of principal for interim ESAF operations would be financed either through extended arrangements (under the General Resources Account (GRA)) or from another round of borrowing by the ESAF Trust. In either case, subsidy resources accumulated in the ESAF-HIPC Trust for the interim ESAF would be available to subsidize those operations.

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[4]After commitments of SDR 0.9 billion in 1996, uncommitted loan resources (out of total contributions of SDR 9.7 billion) amounting to SDR 3.2 billion remain for the period 1997-2000. To reach the target of SDR 10.1 billion of loan resources, an additional SDR 0.4 billion in ESAF loan agreements would be needed. See *ESAF-Update on Status of Operations*, EBS/96/195 (12/19/96).

[5]*Enhanced Structural Adjustment Facility Trust—Extension of Commitment Period*, EBS/96/180 (11/26/96).

Building on the agreements reached in the September meetings, this paper discusses the proposed modalities for special ESAF operations as well as related ESAF issues. Section II discusses the operational modalities for special ESAF operations; Section III describes the financing modalities for those operations (entailing the establishment of an ESAF-HIPC Trust); and Section IV outlines the proposed changes in the current ESAF (requiring amendments in the 1987 ESAF Trust Instrument) to: (i) allow an early transfer of resources from the Reserve Account to the SDA; and (ii) allow more than two three-year ESAF arrangements.

The legal documentation, including the draft Instrument establishing an ESAF-HIPC Trust, will be issued separately.

II. Operational Modalities for Special ESAF Operations

This section describes the operational modalities of a new ESAF-HIPC Trust for special ESAF operations, including eligibility, conditions and amounts of assistance, the terms, and the link to regular ESAF arrangements.

A. Eligibility

Based on the agreed Program of Action, countries would be eligible for assistance from the Fund and the Bank under the HIPC Initiative if they fulfill the following criteria: (i) ESAF-eligible; (ii) IDA-only eligible; (iii) pursue or adopt programs of adjustment and reform supported by the Fund and the Bank in the two-year period beginning October 1, 1996; and (iv) face unsustainable external debt situations[6] at the completion point, even after full application of traditional debt relief mechanisms.[7] For the Fund, criterion (iii) means that a Fund arrangement should be approved or underway during the two-year period from the

[6]External debt sustainability targets for each country will be decided at the decision point on a case-by-case basis by the Boards of the Fund and the Bank, in light of country-specific vulnerability factors; the target for the NPV debt-to-exports ratio at the completion point would be in the range of 200-250 percent and the target for the debt service-to-exports ratio at the completion point would be in the range of 20-25 percent (see EBS/96/135 (8/26/96), page 5).

[7]*Traditional debt relief mechanisms* are defined as the application of Naples terms by Paris Club creditors, including an assumption of a stock-of-debt operation, involving a 67 percent NPV debt reduction of eligible debt at the decision point and at least comparable treatment by other official bilateral and commercial creditors.

beginning of October 1996. This should ideally be ESAF arrangements,[8] but, it is proposed that on a case-by-case basis, the requirement could also be met by stand-by arrangements (SBAs) or Rights Accumulation Programs (RAPs) that are intended to precede ESAF arrangements and would indicate that the country is cooperating fully with the Fund. For post-conflict countries—that are not yet able to develop and implement comprehensive economic programs that could be supported by a Fund arrangement—financial support under the Fund's emergency assistance policy could also be considered to meet the "entry" requirement.

B. Conditions for Assistance under the HIPC Initiative

The conditions for a country to qualify for exceptional assistance under the HIPC Initiative, including from the Fund under special ESAF operations, have been set out in the Program of Action.[9] The key elements are:

- The establishment by the country of a track record—of normally three plus three years, up to the decision and completion points, respectively—of strong policy performance, which would include macroeconomic policies, and structural reforms and social reforms (e.g., improving basic health care and education), monitored under Fund- and Bank-supported programs.

- The required six years of strong policy performance would be implemented flexibly and decided on a case-by-case basis by the Boards of the Fund and the Bank. Countries would receive credit toward the first three-year stage for Fund- and Bank-supported programs already underway at the initiation of the HIPC Initiative beginning October 1, 1996.[10] Exceptionally, the second three-year stage might be shortened for countries that have already established records of sustained strong policy performance. If Fund- and Bank-supported programs have been interrupted during the first stage, countries could also receive some credit for implementation of the program before it went off track, provided significant portions of the program have been sustained and the overall program has been brought firmly back on track. However, after the interruption, the country would need to implement at least one further annual program under a Fund arrangement prior to the decision point.

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[8]In the remainder of this paper, the term *ESAF-supported program* or *ESAF arrangement* is applied to a program or arrangement under the ESAF Trust or the Extended Fund facility, in view of the possible use of the GRA to finance the principal of ESAF-type operations during the interim period (an issue still to be decided by the Board).

[9]EBS/96/152, Revision 1 (9/20/96), page 3, and EBS/96/135 (8/26/96), pages 6-7.

[10]Countries which on that date had already been granted a stock-of-debt operation by the Paris Club on Naples terms (i.e., Bolivia, Burkina Faso, Guyana, Mali, and Uganda) are considered to have completed the first three years of the track record.

- Traditional debt relief mechanisms would not achieve debt sustainability for the country, i.e., the country's NPV debt-to-exports and debt service-to-exports ratios projected for the completion point[11] would be unsustainable: they would be above the country-specific sustainability targets set by the Boards of the Fund and the Bank at the decision point, in the range of 200-250 percent and 20-25 percent, respectively. Alternatively, a country could be considered a *borderline case*, i.e., at the decision point, these ratios would be above or in the upper end of these ranges, and there is a reasonable degree of uncertainty about the achievement of debt sustainability at the completion point.

- All other creditors would have to agree to take action for the country under the Initiative.[12]

The six-year period of strong policy performance for countries under the HIPC Initiative would be under Fund- and Bank-supported programs. For the Fund, it is proposed that during the first three-year period, such programs would be under ESAF arrangements, or, to be determined by the Board on a case-by-case basis, SAFs, SBAs, or RAPs. During the second three-year period, policy performance would be under ESAF arrangements.[13] There would be no difference in ESAF conditionality for countries that are building up a track record under the Initiative and other countries under ESAF support. However, conditionality would reflect the circumstances of the particular country and could place particular emphasis on policy aspects that promote external viability, including debt management;[14] it is envisaged that programs would also emphasize social policies, including the improvement of the quality of

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[11]Projected at the decision point for the completion point, and after assuming full use of traditional debt relief mechanisms at the decision point, as defined above in footnote 7, page 5.

[12]Creditors with claims below a *de minimis* amount would not provide exceptional assistance under the HIPC Initiative. The *de minimis* amount for multilateral creditors is expected to be defined on a case-by-case basis (cf. EBS/96/135 (8/26/96), page 23).

[13]There is a question as to whether a three-year ESAF arrangement would need to coincide with a three-year stage of track record under the HIPC Initiative. This would appear unnecessary for several reasons. In some cases, a new three-year ESAF arrangement might have recently been initiated when a country reaches the decision or completion point. It would then seem costly to cancel the existing arrangement and negotiate a new three-year ESAF arrangement. There would also be cases where a three-year performance record might not be completed with one three-year ESAF arrangement, if the program goes off track. For these reasons, it is proposed that, in general, existing ESAF arrangements would be allowed to run their course. For some cases, where the adjustment effort is coming to an end just prior to the completion point, a fourth-year ESAF arrangement might be appropriate.

[14]As noted above, internal and external reviews of ESAF arrangements are underway. These reviews will, inter alia, discuss issues related to external viability under such arrangements.

public expenditures, the strengthening of institutional capacity, and the delivery of basic social services. At the beginning of the second stage, the Fund and Bank Boards would approve key performance criteria, derived from policy commitments in the Policy Framework Paper (PFP), which would be included in the joint HIPC Initiative Board document to be presented to the Boards at the decision point.

C. Amounts of Assistance under Special ESAF Operations

The amounts of resources to be disbursed under special ESAF operations to countries that qualify for assistance under the Initiative would be decided on a case-by-case basis as described in Box 1.[15]

D. Terms

In Board discussions in June and September,[16] Executive Directors agreed that the Fund's participation in the HIPC Initiative—through special ESAF operations—would take the form of a reduction in the net present value of the country's debt to the Fund through the provision of grants or loans on extended maturities. Decisions on the choice between the two modalities—and a possible blending of the two—would be made on a case-by-case basis by the Board, taking into account the profile after the completion point of the country's debt service to the Fund and to all creditors (after actions by other creditors).

Based on current debt-service projections for countries that might receive assistance from the Fund under the HIPC Initiative, a grant is likely to be the predominant form since it would provide sufficient assistance in most cases. A grant has an obvious presentational value in the context of the Initiative and would not increase the face value of a country's debt to the Fund; it also involves a smaller need for replenishment of resources than a loan to avoid a reduction in the level of self-sustained ESAF operations.[17] However, a loan would provide greater cash

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[15]Based on the Program of Action endorsed in September 1996 (see EBS/96/152, Revision 1 (9/20/96), and EBS/96/135 (8/26/96).

[16]*Concluding Remarks by the Chairman, Framework for ESAF and Fund Participation in the HIPC Initiative*, BUFF/96/75 (6/20/96), and *Summing Up by the Chairman, Financing a Continuation of the ESAF and the Fund's Participation in the HIPC Initiative and Elaboration of Key Features and Proposed Procedures for the HIPC Initiative*, BUFF/96/110 (9/19/96).

[17]See EBS/96/133 (8/23/96), pages 12 and 18-19. While the loan amount would be repaid to the Fund, say 10½-20 years later, some of the repayments would come too late to permit self-sustained ESAF operations at the target level of SDR 0.8 billion per year in the early years, and additional resources would temporarily be needed.

Box 1. Amounts of Special ESAF Operations Under the HIPC Initiative

Based on the agreed Program of Action, the amounts of assistance under special ESAF operations would be decided according to the following steps:

1. The exceptional assistance required from all creditors to bring the actual debt burden at the completion point down to the debt sustainability targets agreed at the decision point for the completion point.

(i) These targets would be set by the Boards of the Fund and the World Bank (after consultation with other creditors) at the decision point on a case-by-case basis in the range of 200-250 percent for the NPV debt-to-exports ratio and in the range of 20-25 percent for the debt service-to-exports ratio. A target range for the NPV debt-to-exports ratio would be specified (of +/-10 percentage points of the target), while the debt service-to-exports ratio would be expected to be below (and continue to be below) the specified target value. The Fund would commit—with other creditors— at the decision point to provide the assistance necessary to bring the projected debt and debt service ratios at the completion point down to the debt sustainability targets.

(ii) If the external debt situation of a member at the completion point, projected at the time of the decision point, would be below the debt sustainability targets as defined, no exceptional assistance by creditors would be committed at the time of the decision point. However, if for a *borderline case* (as defined above), the actual debt situation at the completion point was worse than projected and the targets for debt sustainability were not achieved—and provided that the member did not agree on a stock-of-debt operation with Paris Club creditors on Naples terms after October 1, 1996—exceptional assistance by the Fund and other creditors might be committed and delivered at the completion point.

(iii) If the debt service-to-exports ratio at the completion point or beyond would be above the target specified for the completion point, creditors could consider further action to alleviate the debt service burden, including bilateral rescheduling of remaining debt on nonconcessional terms or, if necessary, a further reduction in the NPV of debt of the member by all creditors.

2. The exceptional assistance required from multilateral creditors to reduce the NPV of their claims.

(i) This is defined as the assistance sufficient to achieve the debt sustainability targets at the completion point, after taking into account the amount of NPV debt reduction provided under the Initiative by Paris Club creditors and at least comparable action by other official bilateral and commercial creditors. The assistance provided by multilateral creditors should involve broad and equitable participation of all creditors and should preserve the financial integrity of the multilateral institutions and their preferred creditor status.

(ii) The amount of assistance to be delivered by multilateral creditors would be increased—subject to decisions by the Boards and to preserving the financial integrity of the multilateral institutions and their preferred creditor status—if, at the completion point, the actual NPV debt-to-exports ratio—after taking into account the exceptional assistance committed by all creditors—were above the upper end of the agreed country-specific target range, due primarily to exogenous and not purely temporary factors. The increase in assistance would be such as to bring the member's NPV debt-to-export ratio down to the upper end of the agreed target range.

(iii) The amount of assistance to be delivered by multilateral creditors could be reduced, subject to decisions by the Boards, if at the completion point, the actual NPV debt-to-exports ratio—after taking into account exceptional assistance committed by all creditors—were below the lower end of the agreed country-specific target range, due primarily to exogenous and not purely temporary factors. The reduction in assistance would be consistent with achieving the originally agreed target range.

3. The exceptional assistance required from the Fund under special ESAF operations at the completion point to achieve the debt sustainability targets at the completion point.

(i) This is based on the Fund's share in the NPV of multilateral debt of the member at the decision point. The assistance under special ESAF operations would be committed to a qualifying member at the decision point in the context of assurances regarding the exceptional assistance to be provided under the Initiative by other creditors.

(ii) The amount that has been committed to a member at the decision point would be confirmed or revised downward or upward at the completion point in light of the actual debt ratio and actual and projected debt-service ratios at the completion point.

(iii) If at the decision point no exceptional assistance by creditors had been committed for a member, but at the completion point the actual debt situation were such that exceptional assistance by creditors would be considered, the assistance for a qualifying member required by the Fund under the Initiative would be committed at the completion point.

assistance and might be needed in cases where a grant would be insufficient to reduce the debt service-to-exports ratio (after special assistance from the Fund and other creditors) below the country-specific sustainability target.[18] In such cases, the grace period and final maturity would be determined on a case-by-case basis, taking into account the need to smooth the country's external debt service profile. It is proposed that the grace period and final maturity would not exceed 10½ and 20 years, respectively. It is also proposed that the interest rate be set at zero percent.[19]

E. Modalities for Commitment, Disbursement, and Use of Resources

According to the Program of Action, the Fund is committed to take action at the completion point (through special ESAF operations) to achieve the reduction in the NPV of debt owed to it by the country qualifying for assistance. This commitment would be made at the decision point, in line with achieving the debt sustainability targets for the country and in the context of assurances regarding exceptional assistance to be provided under the Initiative by other creditors.[20]

Disbursements under special ESAF operations at the completion point would be based on past policy performance and would not be subject to additional specific policy conditions. The disbursement would take the form of a single transfer into an account designated in the name of the country and administered by the Fund for the sole purpose of paying debt service falling due on that country's existing debt to the Fund.[21] At the time of approval of the special ESAF operations, the schedule for using the proceeds in the administered account for paying debt

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[18]For example, a reduction of the NPV of debt of SDR 45 million in end-2000 values could be achieved by an escrowed grant of SDR 45 million at end-2000 or an escrowed loan of SDR 76 million (assuming, for illustrative purposes, a grant element for the loan of 59 percent—consistent with the terms assumed in footnote 19 below).

[19]For a zero interest rate, the grant element of an illustrative loan with 10½ years grace period and 20 years final maturity would be 59 percent (compared with 54 percent in the case of a 0.5 percent interest rate).

[20]However, as noted above, in certain borderline cases, at the decision point, no assistance by creditors would have been envisaged, but it is possible that at the completion point the country's actual debt situation would be such that exceptional assistance by creditors could be considered; in such cases, assistance from the Fund would be committed at the completion point.

[21]The proceeds in the administered account, including investment income, would be counted as an asset of the country, including for the purpose of assessing the NPV of the country's debt; however, they would not be part of the country's international reserves as they would not be freely useable.

service to the Fund would be agreed between the member and the Fund on a case-by-case basis, taking into account the objective to bring the debt service-to-exports ratio (after special assistance from the Fund and other creditors) to the country-specific sustainability target, and, as appropriate, the need for smoothing the profile of the member's total external debt service and debt service to the Fund.[22]

F. ESAF Arrangements after the Completion Point

For countries reaching the completion point and benefitting from special ESAF operations, there would be a presumption that they would continue to pursue sound economic policies and adjustment efforts. As noted above, countries, which at their completion point are in the middle of a three-year ESAF arrangement, would continue under that arrangement. Other countries could request a new three-year arrangement or an additional annual ESAF arrangement at the completion point, depending on their continued need for adjustment policies and for balance of payments assistance from the Fund. For some of these countries that enter a new ESAF arrangement, access would generally be expected to be at a reduced level relative to access under earlier ESAF arrangements.

III. Financing Modalities for Special ESAF Operations

At the September 1996 Board meetings, Directors agreed on the financing framework for the interim ESAF and the Fund's participation in the HIPC Initiative.[23] The interim ESAF, with expected commitments of SDR 4 billion during 2000/01-04, has been estimated to require SDR 1.7 billion in interest subsidies on an "as needed" basis. The principal of interim ESAF operations would be financed from either the GRA (under extended arrangements) or from a new round of bilateral lending to the ESAF Trust. The cost to the Fund of its participation in the HIPC Initiative through special ESAF operations has been estimated at SDR 0.8 billion on the same "as needed" basis.[24]

It has been agreed that special ESAF operations under the HIPC Initiative and the subsidy requirements of the interim ESAF will be financed from bilateral contributions and, if

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[22]As noted above, the amount (and terms) of the special ESAF disbursement would be such as to achieve the reduction in the country's NPV of debt required from the Fund; the actions taken by all creditors would be sufficient to bring the country's NPV debt-to-exports ratio down to the debt sustainability target.

[23]See BUFF/96/110 (9/19/96).

[24]See August Board paper on ESAF, EBS/96/133 (8/23/96). This paper and the August Board paper on HIPC, EBS/96/135, have emphasized that this cost estimate is subject to a wide margin of error and the actual cost will depend on the country-by-country application of the general framework of the HIPC Initiative.

necessary, the optimization of the management of the Fund's reserves. To the extent that other sources of financing are not yet available for this purpose, funding for the special ESAF operations is to be provided through an early transfer of resources from the ESAF Trust Reserve Account to the SDA (see Chart 1).

As discussed in the August ESAF paper, an early transfer and use of Reserve Account resources would need later to be compensated for by other sources of financing to safeguard self-sustained ESAF operations from 2004/05 (at a commitment level of SDR 0.8 billion per year). The self-sustained ESAF would be funded from SDA resources through the transfer of Reserve Account balances when they are no longer needed to provide reserve coverage for outstanding ESAF obligations.

There are several reasons for setting up special ESAF operations in a separate ESAF-HIPC Trust.

- Special ESAF operations could be considered an "add on" to either regular ESAF operations under the existing ESAF Trust Instrument, or to extended arrangements if the principal of ESAF operations is financed through the GRA during the interim period (2000/01-04).

- The operational modalities of special ESAF operations are quite different from those of regular ESAF operations: disbursements are fully up-front and linked to past policy performance, the terms are more concessional, and the proceeds are earmarked for existing debt service to the Fund.

- On the financing side, special ESAF operations (whether grants or loans) would be financed from the SDA and bilateral contributions, whereas the existing ESAF operations are largely financed from bilateral loan and subsidy contributions with protection provided by the resources in the Reserve Account.

In part because the SDA cannot receive bilateral contributions, it is proposed that the special ESAF operations be conducted through a new ESAF-HIPC Trust.[25] This Trust would receive both bilateral contributions (including from SCA-2 refunds) for the HIPC Initiative and transfers from the SDA for the same purpose. It would also be authorized to receive resources

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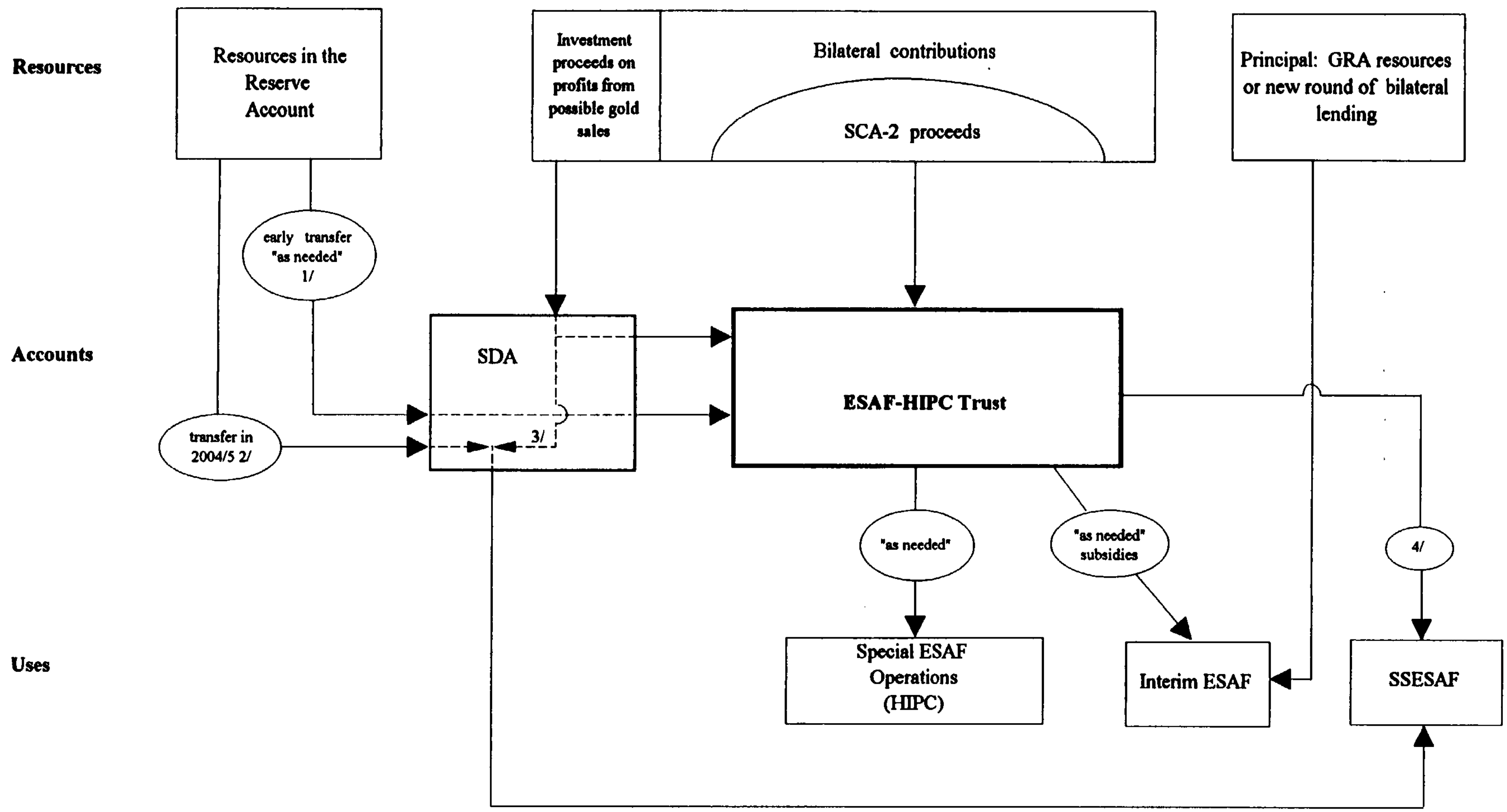
[25]The SDA can only receive: (i) profits from the sale of gold (or the investment income thereon); and (ii) resources that are returned to the SDA once their original purpose has been met (*Articles of Agreement*, Article V, Section 12 (f)).

Chart 1. Financing of Interim and Special ESAF Operations



1/ The early transfer of Reserve Account resources to the SDA and their use for special ESAF operations through the ESAF-HIPC Trust would take place only to the extent that other financing is not yet available.

2/ Transfer of the Reserve Account balance to the SDA to finance self-sustained ESAF (SSESAF) operations from 2004/05.

3/ Remaining resources in the SDA, not used for financing special ESAF or interim ESAF operations, would finance self-sustained ESAF operations from 2004/05.

4/ Remaining bilateral contributions, not set aside for interim ESAF or used for special ESAF operations, would contribute to financing self-sustained ESAF operations from 2004/05.

(including from SCA-2 refunds) for the interim ESAF, pending the establishment of the modalities for interim ESAF operations.[26] As discussed above, special ESAF operations may need to be funded before the proceeds of bilateral contributions, and, if necessary, resources from the optimization of the management of the Fund's reserves, are available. As noted above, the cost to the Fund of the HIPC Initiative has been estimated at SDR 0.8 billion on an "as needed" basis (or SDR 0.35 billion in end-1996 NPV terms). A few countries may reach their decision points—and be judged to qualify for assistance under the Initiative—as early as 1997. The Fund would need to be able to commit resources at that point in an amount equivalent to the value of the targeted reduction in NPV of debt to the Fund (see Box 1, page 9).

Several options for making early transfers, if necessary, from the Reserve Account to the SDA for the purpose of special ESAF operations could be considered. One option is a lump-sum transfer equal to the projected assistance required for countries likely to qualify between the time of the transfer and the time other resources to fund special ESAF operations become available. Given the uncertainty about the timing and amounts of the required assistance and about the availability of bilateral contributions and other resources, a lump-sum transfer might need to be relatively large and could unnecessarily reduce the reserve coverage of ESAF Trust creditors. A second option would be to make a transfer each time that special ESAF resources under the HIPC Initiative are committed, i.e., at countries' decision points. A third option—preferred by the staff—would be to effect a transfer only at the time of the disbursement of each special ESAF operation so as to minimize the early transfer from the Reserve Account.

To avoid that a decision to transfer resources would need to be taken by the Board each time a country reaches its decision point, it is proposed that the Board approve a transfer up to a certain limit and for a certain period (see Section IV.B below).

It should be noted that the earlier bilateral ESAF contributions or resources from the optimization of the management of the Fund's reserves could be made available, the less would be the need for early transfers from the Reserve Account. In addition, it would be preferable to avoid earmarking of bilateral contributions for particular purposes (that is, as between financing of interim ESAF subsidies and financing of special ESAF operations under the HIPC Initiative), although the wishes of contributors in this respect will need to be accommodated.

There are considerable uncertainties as to the timing of available financing for continued ESAF operations (including the Fund's contribution to the HIPC Initiative) as well as to the cost to the Fund of the special ESAF operations. In this context, it is important to ensure that the financing of ESAF subsidy requirements during the interim period (SDR 1.7 billion on an

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[26]As noted above, the legal documentation including the draft Instrument establishing a new ESAF-HIPC Trust, will be issued separately.

"as needed" basis) is sufficient to permit an annual commitment level of SDR 1 billion—which should be considered a minimum. In light of this, it would seem desirable to review, on a semi-annual basis, the financing available for these initiatives and the Fund's commitments.

IV. LEGAL MODALITIES FOR SPECIAL ESAF OPERATIONS AND OTHER ESAF ISSUES

This section sets out the legal steps necessary for establishing the ESAF-HIPC Trust and discusses related changes to the existing ESAF Trust Instrument.[27]

A. Legal Steps for Establishing the ESAF-HIPC Trust

The following steps are necessary to establish special ESAF operations:

(i) a decision by the Board—with a 50 percent majority of the total voting power—to establish the ESAF-HIPC Trust for special ESAF operations (and to receive interim ESAF subsidy contributions);

(ii) a decision by the Board—with a 50 percent majority of the total voting power—to amend the ESAF Trust Instrument (as described in Section B below);

(iii) agreement by all ESAF Trust creditors to the early transfer of resources from the Reserve Account to the SDA up to a limit; and

(iv) a decision by the Board—with an 85 percent majority of the total voting power—to use the resources in the SDA for special ESAF operations through the ESAF-HIPC Trust Account.

B. Amendments to the ESAF Trust Instrument

This section proposes two amendments to the existing ESAF Trust Instrument that are related to the establishment of the ESAF-HIPC Trust.

1. Early transfer to the SDA from the Reserve Account

The Reserve Account balance is projected to amount to SDR 1.7 billion at end-1996, equivalent to 38 percent of outstanding ESAF obligations; it is projected to reach SDR 4.5

[27] As noted above, the legal documentation will be issued separately.

billion by end-2004 when it would provide 100 percent reserve coverage (see Annex I).[28] The size and timing of the required early transfer would depend on the assistance to be provided by the Fund under the HIPC Initiative as well as the availability of other resources. Both of these factors are subject to substantial uncertainty. However, it is projected that the countries that could be expected to account for a large share in the total are unlikely to reach their decision points before 2000. Based on the staff's estimate of the cost to the Fund of the HIPC Initiative in the August Board paper (EBS/96/133 (8/23/96)) of SDR 0.35 billion in end-1996 NPV terms—and without taking into account expected bilateral contributions during that period— SDR 250 million is judged to be a generous maximum of the amount that could be needed during 1997-2000. If bilateral resources are available, the transfers would be lower. The proposed transfer would have only a relatively limited impact on the reserve coverage. Without such transfers, the Reserve Account balance is projected to increase from 38 percent of outstanding ESAF obligations at end-1996 to 47 percent at end-2000, or 43 percent on average. Assuming such transfers were to take place at the time of each disbursement for special ESAF operations, the average reserve coverage would be 41 percent of outstanding ESAF obligations during 1997-2000 and coverage would amount to about 43-44 percent at end-2000, only some 3-4 percentage points below what it would have been without early transfers.[29] Based on the understandings reached by the Board in the September 1996 discussions, it is proposed that the Board approve an early transfer to the SDA from the Reserve Account, up to a maximum of SDR 250 million during the period 1997-2000, with actual transfers taking place as needed. After Board approval, the consent of each individual creditor for this transfer would be sought.[30]

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[28]As noted in Annex I, this projection depends on the assumption that the six-month SDR interest rate would be 6 percent for the remaining life of the current ESAF Trust. Current interest rates are considerably below 6 percent, although there are indications of an upward trend. See *ESAF-Update on Status of Operations*, EBS/96/195 (12/19/96) for an analysis of the sensitivity of these projections to interest rate changes.

[29]See Chart 1 in Annex I.

[30]In this context, it is useful to recall the Fund's commitment embodied in the 1987 decision establishing the ESAF Trust that "The Fund is committed, if it appeared that any delay in payment by the Trust to lenders would be protracted, to consider fully and in good faith all such initiatives as might be necessary to assure full and expeditious payment to lenders." (*Selected Decisions*, Twenty-First Edition, June 1996, page 22; reiterated in the Chairman's Concluding Remarks of the September Board meeting (BUFF/96/110 (9/19/96)). At the time of the 1987 Board meeting, it was understood that "all such initiatives as might be necessary" include the possible use of gold (see *Summing Up* of EBM/87/171 (12/15/87), *Selected Decisions*, Twenty-First Edition, June 1996, page 43).

2. Removing the limitation of two three-year ESAF arrangements

The existing ESAF Trust Instrument, as amended at the time of the extension and enlargement of the ESAF in December 1993, allows for a second three-year ESAF arrangement after expiration of the original arrangement.[31] The possibility of repeat use of ESAF resources was agreed by the Board in order to permit continued support to countries in their comprehensive macroeconomic and structural reform efforts under a difficult external environment.[32] At the same time, the external positions of many ESAF-eligible countries remained fragile, suggesting a continuing need for balance of payments support. While improved economic performance is emerging in a number of countries supported by the ESAF—including in Africa—there is a clear need for a continuation of ESAF-supported programs, as was endorsed by the Board during discussions on a continuation of the ESAF during the last one and a half years.[33] In addition, the HIPC Initiative has created a new opportunity for the countries facing an unsustainable external debt burden and that sustain strong policy performance to benefit from exceptional assistance.

In this context, it is proposed that the current limit of two three-year ESAF arrangements be lifted, in order to:

- permit non-HIPC ESAF-eligible countries to have ESAF arrangements as necessary to complete their economic adjustment efforts and to deal with future unanticipated needs;

- permit HIPCs to establish a track record of three plus three years up to the completion point under ESAF-supported programs as necessary, and thereby qualify for assistance under the HIPC Initiative; and

- make possible ESAF arrangements for HIPCs benefitting from special ESAF operations after the completion point, if needed to accompany the country's continued adjustment efforts.

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[31] Annex to the ESAF Trust Instrument Decision, Section II, paragraph 1(b), *Selected Decisions*, Twenty-First Edition, page 25.

[32] See Summings Up of the Board discussions on the *Review of Experience Under ESAF-Supported Arrangements*, BUFF/93/11 (3/24/193), and on the *Operational Modalities and Funding Alternatives for an ESAF Successor*, BUFF/93/15 (4/12/93).

[33] See the Board discussion on the continued financing and adaptation of the ESAF in September 1995 (BUFF/95/95 (9/14/95)).

V. SUMMARY

This paper presents a proposal for the operational and financing modalities of a new ESAF-HIPC Trust for special ESAF operations under the HIPC Initiative (and for receiving bilateral subsidy contributions for interim ESAF operations). It responds to the Interim Committee's request to proceed quickly with implementation of the HIPC Initiative and to report on progress in Spring 1997. As the eligibility of a few HIPCs for assistance under the Initiative could be assessed in early 1997, there is a particular urgency to establishing this Trust and assuring its financing, so as to allow the Fund to commit resources at the decision point to countries qualifying for assistance from the Fund under the Initiative.

Operational modalities. The paper sets out the criteria for countries' eligibility for the HIPC Initiative; the conditions for qualifying for, and the amounts of, assistance under special ESAF operations, all of which are in line with the Program of Action for the HIPC Initiative already endorsed by the Boards of the Fund and the Bank and the Interim and Development Committees in September; it also sets out the terms and modalities for use of resources disbursed under special ESAF operations, and their relation to regular ESAF operations.

Financing modalities. The paper proposes that special ESAF operations be conducted through a new ESAF-HIPC Trust. The special ESAF operations would be financed by bilateral contributions (including use of SCA-2 refunds) and transfers from the SDA. The Trust would also receive bilateral contributions (including use of SCA-2 refunds) and transfers from the SDA for ESAF subsidies during the interim period 2000/01-04.

Amendments to the 1987 ESAF Trust Instrument. The paper proposes a change in the ESAF Trust Instrument to allow an early transfer of Reserve Account resources to the SDA up to a maximum of SDR 250 million during the period 1997-2000 for the financing of special ESAF operations, but only to the extent that other financing resources for this purpose are not yet available. After Board approval of the proposed amendment, the consent of each of the individual ESAF creditors would be sought.

In addition, it is proposed that the ESAF Trust Instrument be amended to remove the limitation of two three-year ESAF arrangements.

* * *

The ESAF-HIPC Trust would become operational upon the Board's decisions and the subsequent approval by each of the ESAF Trust creditors of the early transfer from the Reserve Account to the SDA.

ESAF Trust Reserve Account

Under the terms of the ESAF Trust Instrument, the resources in the Reserve Account provide protection to the lenders to the Loan Account of the ESAF Trust. The degree of protection provided to lenders to the Trust depends on the accumulation of funds in the Reserve Account and the size and timing of the Trust's obligations. In the absence of arrears, the protection provided by the Reserve Account will increase over time, as resources in the Reserve Account (stemming from transfers from the SDA—reflecting the repayment and interest of SAF, the Trust Fund, and the SDA financed portion of ESAF loans—and accumulated investment income) increase rapidly while the ESAF Trust obligations are projected to start to decline by the year 2001 (Table 1 and Chart 1). Resources in the Reserve Account will be retransferred to the SDA to the extent that the Trustee determines that the resources in the Reserve Account exceed the amount needed to cover the liabilities of the Trust. After retransfer to the SDA, these resources could be used for various purposes, including to finance ESAF-type operations, subject to decisions of the Executive Board that require 85 percent of the total voting power (or, for transfer to the GRA, a 70 percent majority of the total voting power).

The starting point for the retransfer of resources—and thus operations under a self-sustained ESAF—could be brought forward if lenders to the Trust's Loan Account were to conclude that the Reserve Account did not need to build to full coverage of Loan Account obligations. Lenders might also conclude that in order to accept a reduction in the protection offered by the Reserve Account, they would need another form of protection, for example through an additional gold pledge. Considerations concerning the modalities and size of such a pledge are discussed in EBS/96/2 (1/11/96), Section III.

Table 1. Projections of Trust Reserve Account
and Obligations of the Trust
(as of October 31, 1996)

(In millions of SDRs)

	Net Transfers from SDA 1/ 2/	Investment Earnings 1/	Net Payments(-) from the Reserve Account 3/	Cumulative Total (end of period) 4/	Trust Obligations (end of period) 5/	Annual Loan Repayments from the Trust 6/
1. Actual						
1988	165	4	--	169	103	--
1989	79	24	--	272	360	--
1990	81	42	--	395	674	--
1991	77	41	--	513	1,262	--
1992	79	38	--	630	1,763	--
1993	134	29	--	793	1,990	--
1994	179	41	-4	1,009	2,786	33
1995	279	66	-18	1,336	3,919	114
1/1/96 - 10/31/96 7/	235	62	-23	1,610	4,267	132
2. Projected 8/9/						
1996	318	73	-21	1,706	4,446	181
1997	348	112	-9	2,157	5,533	285
1998	289	137	-5	2,578	6,314	366
1999	292	161	-2	3,029	6,704	412
2000	102	184	29	3,344	7,119	475
2001	83	201	21	3,649	7,000	665
2002	40	218	9	3,916	6,530	738
2003	32	233	5	4,185	5,732	911
2004	36	249	2	4,472	4,693	1,068
2005	29	265	0	4,766	3,616	1,076
2006	-8	282	0	5,040	2,637	980
2007	-8	298	0	5,330	1,737	900
2008	-8	315	0	5,637	1,048	688
2009	-8	333	0	5,962	576	473
2010	-8	352	0	6,307	253	322
2011	-8	373	0	6,672	91	162
2012	-8	394	0	7,058	25	65
2013	-8	417	0	7,468	3	23
2014	-8	442	0	7,902	0	3

Note: Totals may not add due to rounding.

1/ Projections of income are at an assumed interest rate of 6.0 percent. Actual investment returns may differ.

2/ Amount shown is net of payments to reimburse the General Resources Account for SAF/ESAF administrative expenses. In FY96 the reimbursement amounted to SDR 24 million. In the projections, it is assumed that these expenses will amount to SDR 24 million in each of the years 1997-2003 and SDR 8 million in each of the years 2004-2014, and will be paid from the Reserve Account.

3/ Corresponds to temporary transfers from the Reserve Account. Starting in 1995, figures reflect transfers and offsetting receipts resulting from a mismatch in timing between repayments to the Swiss Confederation and repayments from borrowers related to the Swiss loan. Actual figures for 1994 to October 31, 1996 also include temporary transfers resulting from a mismatch in timing of interest received from borrowers and paid to lenders.

4/ Includes accrued interest through end of period, although not yet received.

5/ Does not include associated loans from the Saudi Fund for Development (SFD), the risk of which is borne by the SFD.

6/ Does not include repayments of SFD associated loans.

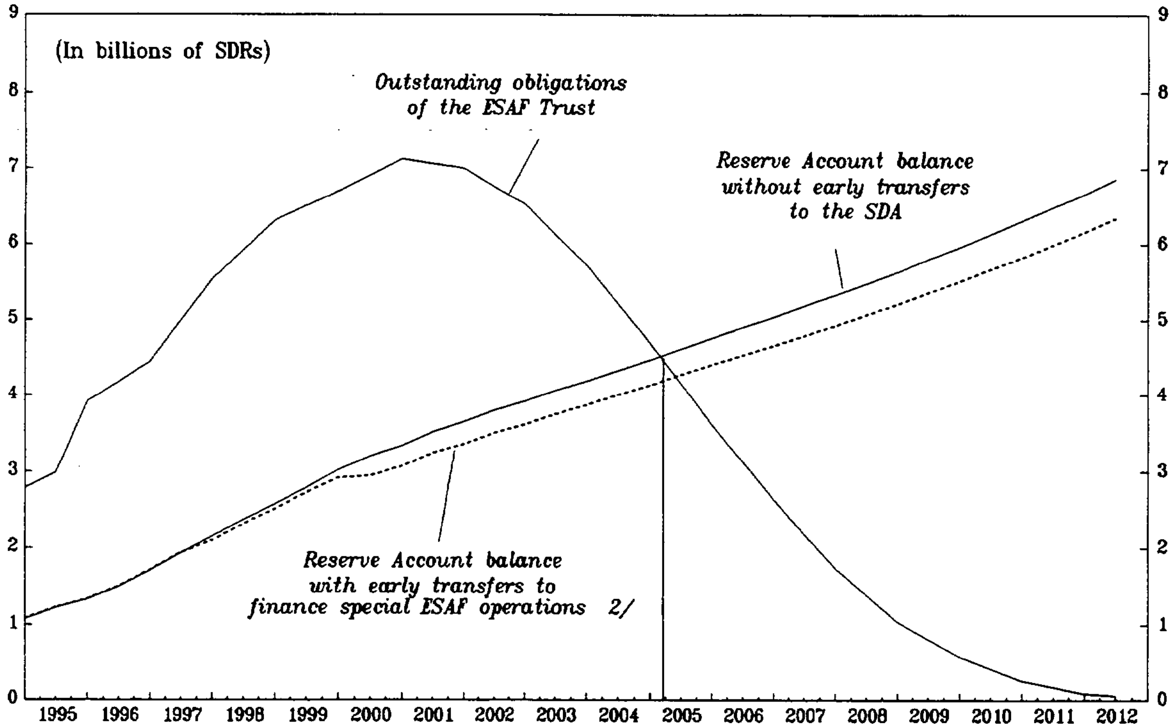
7/ The cumulative total includes SDR 6 million of accrued interest on investments and SAF loans that has not yet been received.

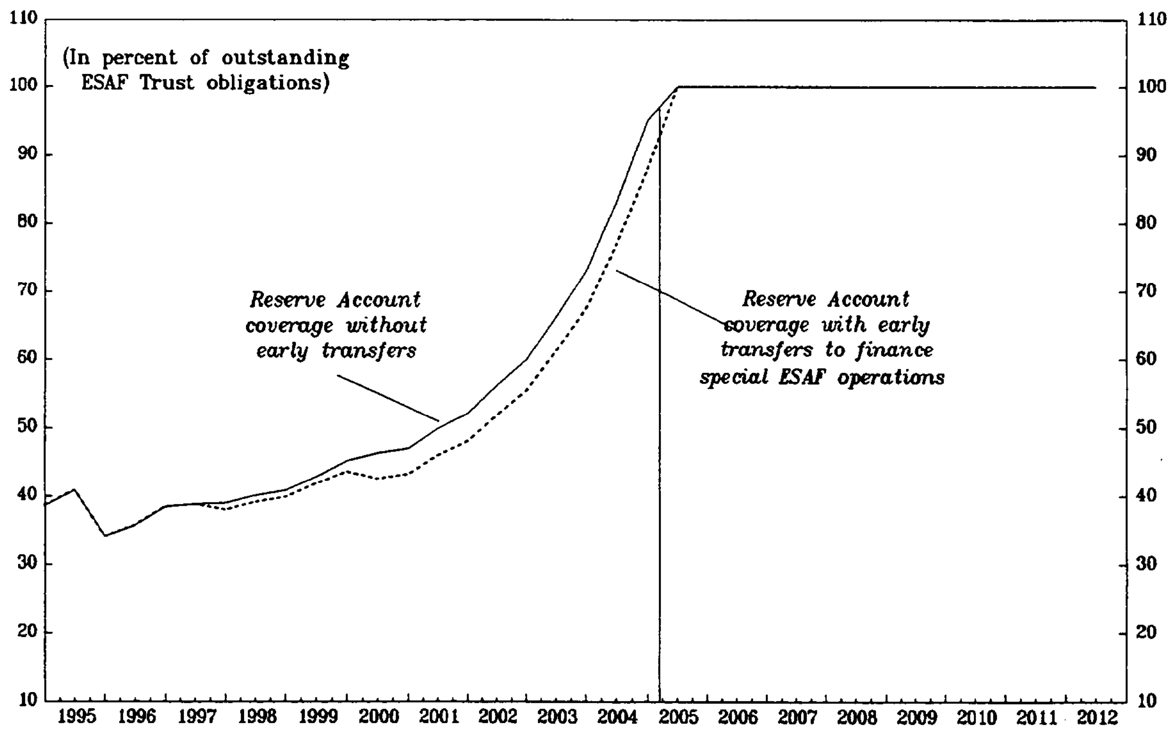
8/ Overdue Trust Fund obligations outstanding as of October 31, 1996 (SDR 120 million) are assumed to be paid in 1998-2001. It is also assumed that total overdue SAF obligations outstanding as of October 31, 1996 (SDR 90 million) will be paid in 1997-2000.

9/ Projections take into account total transfers of SDR 400 million from the SDA to the Subsidy Account (rather than to the Reserve Account) that were made in 1994.

CHART 1

ESAF Trust and Reserve Account With Early Transfers for the HIPC Initiative 1/





Source: Staff estimates.

1/ Assumes potiential ESAF Trust resources of SDR 10.1 billion will be fully committed by late-2000; excludes the effects of a self-sustained ESAF.

2/ The assumed early transfers are based on the estimated NPV debt reduction required from the Fund under the HIPC initiative for countries that could reach their completion points during 1997-2000 (a total undiscounted transfer of of SDR 250 million).