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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/133

10:00 a.m., September 27, 1991

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	
	Deng H., Temporary
	J. Jamnik, Temporary
T. C. Dawson	Q. M. Krosby
	J. Prader
E. A. Evans	
	N. Kyriazidis
M. Finaish	
M. Fogelholm	I. Fridriksson
H. Fukui	
	B. Esdar
J. E. Ismael	T. Sirivedhin
	J. C. Jaramillo
J.-P. Landau	I. Martel
A. Mirakhor	
L. B. Monyake	
	P. Wright
G. A. Posthumus	
	B. A. Sarr, Temporary
A. Torres	R. Marino
	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
C. P. Clarke, Assistant

Also Present

IBRD: F. Kilby, Risk Management and Financial Policy Department. African Department: R. C. Williams. Southeast Asia and Pacific Department: K. Saito, Director; J. E. Leimone. European Department: A. Chopra, J. Odling-Smee. Exchange and Trade Relations Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; J. C. Di Tata, M. A. El-Erian, A. Jansen, G. G. Johnson, M. G. Kuhn, K. H. Lee, A. Leipold, P. Mylonas, R. M. Schramm, P. J. P. Szymczak, P. R. Wade. External Relations Department: S. J. Anjaria, Director; V. R. Khanna, J. E. McEuen. Legal Department: R. H. Munzberg, Deputy General Counsel; P. L. Francotte, A. O. Liuksila. Middle Eastern Department: W. Makarem. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; M. P. Dooley, P. Gajdeczka, R. D. Haas, E. L. Rojas-Suarez, S. A. Symansky, K. S. Warwick. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; A. Tahari. Statistics Department: B. Ozer. Treasurer's Department: D. Williams, Treasurer; D. Gupta, S. M. Thakur. Western Hemisphere Department: M. Caiola, Deputy Director; A. Elson. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: M. A. Ahmed, L. D. Dicks-Mireaux, M. J. Mojarrad, M. Nakagawa, Y. Patel, F. A. Quirós, B. Szombati, S. von Stenglin. Assistants to Executive Directors: B. Abdullah, T. S. Allouba, Chen M., J. A. Costa, S. B. Creane, T. P. Enger, N. A. Espenilla, Jr., H. Golriz, S. Gurumurthi, M. A. Hammoudi, M. E. Hansen, K. M. Heinonen, J. Jonas, R. Meron, R. Powell, S. Rouai, S. Shimizu, N. Sulaiman, C. M. Towe, J. W. N. P. M. van der Kaaij, J. C. Westerweel.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mrs. Martel as Alternate Executive Director for France.

2. REPUBLIC OF LATVIA - APPLICATION FOR MEMBERSHIP

The Deputy Managing Director informed the Board that an application for membership from the Republic of Latvia had been received in the Fund on September 27, 1991 (EBD/91/275, 9/27/91).

3. REPORT BY DEPUTY MANAGING DIRECTOR

The Deputy Managing Director said that on September 22-25, 1991 he had participated in a conference in Tallin, Estonia, which had been convened by the Prime Ministers of Estonia, Latvia, and Lithuania. During the conference, in which senior economic officials from each of the Baltic Republics had participated, the authorities of each of the Republics had indicated their desire to move as quickly as possible toward membership in the Fund and the World Bank. In response, he had made it clear that the Fund would move expeditiously on the matter; indeed, the conference had provided an early opportunity for the Republics and the Fund to get acquainted. Moreover, he had asked the senior staff member who had accompanied him to the conference to stay on for a few extra days to visit each of the capitals to obtain further information about the Republics' economies. He had indicated to the authorities, however, that it was difficult to predict how long the membership process would take; on the basis of the experience of less complicated cases, he had suggested that the process probably could not be completed before spring 1992. In that context, there had been some discussion about the difficult data issues that were involved in trying to estimate all of the variables needed during the membership process; separating the data for the economies of the individual Republics from those for the U.S.S.R. would be especially difficult, as the authorities already well understood. In addition, he had also indicated that it would be important to have information on official assets and liabilities, including those that might be related to any arrangements for the Republics' separation from the U.S.S.R.

Beyond the membership process, the Deputy Managing Director continued, the authorities had been anxious to receive immediately as much assistance as possible in analyzing and developing policy options, particularly in the area of currency reform, as each Republic intended to implement currency reforms during the course of 1992. Furthermore, the authorities had expressed interest in technical assistance from the Fund and the World Bank in a number of other areas, such as central banking, budgeting, and statistics. While there was still some institutional memory within the Republics, each Republic had, in essence, to build new institutions in every area of economic management, including central banks and budget ministries. Accordingly, they were looking for assistance, particularly from the Nordic countries, in helping to build those institutions and train individuals to staff them. Among the officials he had met, there had also been great interest in a stabilization fund. In that context, he had made the point that, while currency reform and, possibly, a stabilization fund were important, the underlying economic policies would be crucial to the success of a reform effort. A stabilization fund might be a useful addition in the later stages of a program of reform and stabilization, but, in the absence of sound underlying policies, the stabilization fund would be quickly exhausted. Moreover, if the underlying policies were present, a stabilization fund would probably be redundant.

The conference had also provided an opportunity for each of the Prime Ministers, as well as their ministers, to talk about the reforms that they were already implementing, the Deputy Managing Director remarked. Some cooperative arrangements were already in place among the Republics, but they were also considering about 20 additional areas of mutual cooperation. In addition, the authorities had discussed their working relationships with the Republics of the U.S.S.R. It seemed that the Baltic Republics maintained barter arrangements and close working relationships at the enterprise level with the other Republics, and there had even been some discussion on extending those arrangements. He had been given the impression that the Baltic Republics had been able to maintain their trade relations with individual Soviet Republics, although there had been some decline in activity; the decline did not, however, appear to be as severe as the reduction in trade between the U.S.S.R. and the Eastern European economies. Prior to the conference, a meeting of high-level representatives from the Baltic Republics and the individual Republics of the U.S.S.R. had been held in Tallin. At that meeting, participants had discussed, inter alia, their respective plans for currency reform as well as the concept of a common currency exchange. Similar meetings were expected to take place in the future on currency and other matters.

It was his understanding that there had been discussions among all of the Republics, including the Baltic Republics, on the allocation--based on different formulas--of the assets and liabilities of the U.S.S.R., the Deputy Managing Director said. One such formula, for example, had suggested that Estonia's share would be 0.5 percent, while Russia's would be on the order of 62 percent; there was probably a heavy population weight in that calculation.

The officials that he had met, including the Prime Ministers, had been anxious to move toward market reforms and to do so quickly, the Deputy Managing Director stated. Nevertheless, he had a sense that they would have a great deal of difficulty in bringing their respective Parliaments along in that process. In addition, there were important issues that each of the Republics had yet to deal with, such as citizenship, the treatment of minorities, restitution, and land reform, which would have to be resolved simultaneously with reforms in the areas of banking, budgeting, trade, and economic management more generally.

The Executive Directors took note of the report by the Deputy Managing Director.

4. REPORT BY MANAGING DIRECTOR

The Managing Director said that one of the subjects that was bound to come up in Directors' conversations with their authorities in preparing for the Annual Meetings in Bangkok was the progress with regard to consents to quota increases under the Ninth General Review and acceptances of the Third Amendment of the Articles of Agreement. While some members--and, indeed, whole constituencies--had completed work on both matters, much remained to be done by many other members, which was a cause for concern. It was particularly worrying that the process of ratification of the Third Amendment was lagging seriously and dangerously behind the process of consents to the increases in quotas. In a few weeks, a situation could emerge in which the necessary majority for the quota increase had been--or was about to be--reached, while the required 85 percent majority for the coming into effect of the Third Amendment was still a distant prospect. He appealed to Directors to urge the authorities of those members that had not yet done so to proceed immediately with the necessary steps for signifying their acceptance of the Third Amendment. Of course, in many cases parliamentary action was required, and a number of members had reservations about the Third Amendment itself. Nevertheless, the fact remained that the quota increase could not come into effect until the Third Amendment had been ratified by the required majority.

The reservations held by some members about the Third Amendment concerned him more than the slow pace of ratification, the Managing Director remarked, because they implied that there were still misunderstandings about the way in which the Fund would use the powers envisioned under the Third Amendment. He fully recognized that, at the time of the discussions on the proposed Third Amendment, several Directors had had mixed feelings about the proposal. Nevertheless, after the Fund's recent experience in dealing with arrears countries, in applying the rights strategy, and in showing a degree of understanding for the individual situation of countries where political conditions were very unsettled, suspicions about the application of the measures provided for under the Third Amendment were no longer justified. Indeed, he would welcome an opportunity to meet with any ministers who continued to hold the slightest reservation about the way in which the Fund would use the powers granted to it under the Third Amendment.

The membership had urged the Fund to work on a number of new issues and to do its traditional work better, the Managing Director commented. If the Fund was to do what was expected of it, however, it would need the means to do so, and enactment of the Third Amendment was important in that regard.

It was to be hoped that there would be no further delay. The membership of the Fund should be seen as supporting fully the institution at the present critical juncture. Finally, it would be most helpful if he could receive from Directors in the coming days progress reports on all countries that had not yet accepted the Third Amendment. He was confident that those reports would convey encouraging news.

Mr. Monyake said that his chair fully supported the Managing Director's efforts. Those members that had not voted for the resolution on the Third Amendment faced a dilemma, however, as some members that had voted for the resolution had still not taken the necessary steps toward ratification. That situation had, in part, delayed the efforts of members that continued to hold reservations about the amendment.

The Managing Director considered that it was important to recognize that parliamentary procedures were more complex in some countries than in others. Moreover, it appeared, perhaps ironically, that the countries that were most in need of an increase in quotas were those that were currently hesitating and waiting for others to take action first.

The Executive Directors took note of the Managing Director's report.

5. MANAGEMENT OF DEBT SITUATION

The Executive Directors considered a staff paper on management of the debt situation (EBS/91/154, 9/10/91; and Cor. 1, 9/18/91). They also had before them a background paper on private market financing for developing countries (SM/91/193, 9/16/91).

Mr. Ismael made the following statement:

> The staff's review of recent developments in the debt strategy is a well argued paper touching on a number of important points, although often in a fashion that minimizes the need for change in the strategy currently in place. In at least one area, debt relief for performing middle-income countries, I feel that this conservative assumption should not be left without more critical examination. Otherwise, I am in broad agreement with the staff, and I am inclined only to develop the points made in the staff paper.
>
> In its concluding section, "Summary and Issues for Discussion," the staff paper invites comment on a series of points. These seem to be related to three principal themes: (i) the importance for the success of the debt strategy of a favorable environment for private capital inflows; (ii) the time required to negotiate debt reduction packages and the consequent need for official financing during this period; and (iii) the progress

recently made in providing official debt relief to the heavily indebted low- and middle-income countries.

On the first point, the value of the staff's focus on private capital flows lies in its minimal emphasis on short-term balance of payments considerations--which often drive debt renegotiation exercises--and the importance that it places instead on the creation of suitable conditions for sustained, long-term growth, which will determine the debtor country's capacity to repay the bonds arising from such negotiations. This analytical approach suggests that short-term adjustment policies designed to address internal and external imbalances are necessary but not sufficient for the success of debt reduction exercises, and that equal, if not greater, attention must be given to structural reforms in such areas as corporate taxation, foreign investment restrictions, and domestic capital market regulations. If foreign equity inflows are to be encouraged, reforms in these areas are just as important as the correction of short-term external imbalances. This, in turn, implies the need for multiyear programs of reform under the guidance of both the Fund and the World Bank.

Linked to this emphasis on private capital flows is the staff's focus on market indicators of country risk, such as debt prices and bond yields. The staff points out the need to factor these indicators into official assessments of sovereign risk, including the country risk matrices applied by bank regulators. Arguably, bank regulators have lagged far behind the developing country debt market in properly assessing the repayment risk of the heavily indebted countries, and they may now lag the markets again in evaluating the improved risk profile of many of the same countries. Greater emphasis on market indicators may offset to a degree this regulatory lag.

At the same time, to stimulate private capital flows, the staff also suggests that official data on the economic performance of the heavily indebted developing countries be disseminated to market participants in a timely fashion. Where it is inappropriate to disclose confidential documents, use can, perhaps, be made of institutions specializing in risk assessment--such as bond and country risk rating agencies, official bodies providing investment and export credit insurance, and bank regulators--to allow improving economic trends and performance to be reflected in the pricing of capital flows.

A second theme implicit in the points for discussion is the time-consuming nature of the structural reforms required to sustain a comprehensive debt and debt-service reduction program, and the need, therefore, for extensive financial assistance from official sources during the negotiation of such a package with creditor banks.

The Venezuelan debt reduction exercise is a case in point. Negotiations with the banks lasted for over a year, but during this period, Venezuela was able to put in place not only a short-term stabilization program but also the principal elements of a long-term plan of structural reform. Rapid and large disbursements by the Fund and the World Bank provided Venezuela with the necessary financial support to sustain these reforms, which, in turn, were instrumental in convincing creditor banks of the seriousness of the economic restructuring effort and the value of supporting it through a Brady-style debt reduction package. Had the multilateral agencies insisted, as they have in the past, on the negotiation of a bank agreement prior to the disbursement of official funds, Venezuela would have lost time and political support for implementation of its economic reform program, and the banks themselves would have had little basis for forgiving a significant portion of their claims. Implementation of the structural reform program prior to the debt agreement was critical to the Government, in the context of both its internal political situation and its external bank negotiations. Importantly, this sequence was possible only with the timely support of the multilateral financial institutions. While such support may imply increased involvement and risk for these institutions in the short run, this strategy is the most promising one for restoring the balance of payments stability of heavily indebted member countries.

It should be noted, however, that Venezuela was quickly able to avail itself of such large official disbursements precisely because it had not borrowed extensively from official sources in the past. In the case of those heavily indebted countries whose borrowing from the multilateral agencies is already high, the multilateral agencies may not be able to support the implementation of a structural adjustment program as effectively as they did with Venezuela's.

A second suggestion by the staff to facilitate the negotiation of debt reduction agreements is the use of contingency clauses. As the staff emphasizes, radical programs of structural reform can be sustained only through the renewed inflows of private capital, and, to this end, an external debt-service schedule must be put in place that is perceived as realistic by the markets. It is difficult to agree on such a schedule in bank negotiations, however, where radically different perceptions of the debtor's capacity to pay must be reconciled. This is particularly true in the early stages of implementation of the adjustment program. In this context, the use of symmetric contingency clauses could be a helpful innovation.

On the third issue for discussion in the staff paper, a number of creative ideas are developed in the paper in respect of bank debt reduction, but few new ideas are noticeable in the discussion of official debt relief, particularly for such performing middle-income countries as Indonesia and Colombia. In both cases, a pattern of strong and steady economic growth may now be constrained by a heavy debt-service burden, reflecting primarily an excessive level of official debt. The staff's suggestion that the "special situations of some lower middle-income countries...be examined on a case-by-case basis" leaves the door open to creative solutions. The ideas that follow are offered in this context.

Given the rapid economic growth in recent years of several lower middle-income countries, one concept that can perhaps be explored is the exchange of official debt for some form of equity participation in the debtor country's economy. Such participation could be represented by a local currency financial instrument whose yield would be linked to the rate of growth of nominal GDP, and which could be redeemed for foreign currency only when the debt-service ratio had returned to a manageable level. In this way, official creditors might increase their returns by deferring repayment. An extension of this idea would be the exchange of official debt for participation in a publicly traded closed-end fund investing in a broad index of local stocks. Alternatively, official claims might be exchanged for local currency bonds, as Chile did with its private debt, the proceeds from the sale of which might be used for inward investment.

A second direction that might be followed in dealing with the official debt of heavily indebted countries is to reduce the volatility of the service of this debt, thereby reducing its risk to the debtor country and presumably enhancing the country's attractiveness to private lenders and investors. As most of the debt is represented by fixed-rate, long-term obligations, the risk to the debtor lies primarily in exchange rate volatility, which can increase the cost of nondollar debt service relative to largely dollar-denominated export streams. Mechanisms to stabilize the dollar cost of official debt service should be explored, possibly through the automatic financing of increases in dollar debt service attributable to sharp fluctuations in exchange rates. Such financing, which would be temporary in nature, could be repaid when conditions in the foreign exchange market improved.

In conclusion, given the development of a model for private debt reduction, and the success of this model in restoring private capital flows, the staff should perhaps now focus their attention on the more difficult issue of official debt relief.

Mr. Evans made the following statement:

Any review of the effectiveness of the debt strategy must be related to attainment of its basic objectives: revival of access to spontaneous official and private flows for debtor countries, and a return to satisfactory economic growth for those countries.

Recent available information suggests that the basic objectives of the debt strategy are unlikely to be attained during the immediate period 1991-92. Revival of spontaneous access for severely indebted countries, which would be consistent with a return to medium-term viability, has been limited to a handful of countries--notably, Mexico, Venezuela, and Chile. Moreover, even for these countries, market access has been fairly limited in scale and has often required imaginative and possibly more costly structuring to improve the credit risk. The use of various enhancement techniques is well described in pages 24-31 of SM/91/193. The slow progress to medium-term viability is further underscored by the low ratio of actual debt service to scheduled debt service. For severely indebted low-income countries (SILICs), that ratio was a very low 26.1 percent in 1990. Moreover, the ratio of repayment to creditor banks was even lower at 7.8 percent. The comparable ratios for severely indebted middle-income countries (SIMICs), at 58.4 percent overall and 30.6 percent to commercial banks, are better but still well below that consistent with a return to market access. Meanwhile, highly indebted countries have yet to return to faster growth on a sustainable basis. The latest world economic outlook paper (EBS/91/146, 8/30/91) confirms that real GDP in net debtor countries with recent debt-servicing difficulties declined by an average 2 percent a year in 1990-91, compared with an average median growth of 3.2 percent for developing countries as a group over the same period.

Nevertheless, while a return to viability by debtors has been slow, the underlying threat to the international financial system, a very real danger in the early stages of the debt crisis, seems to have been steadily defused. The reduced systemic threat can be seen clearly in the marked strengthening of the financial position of international banks. The data for U.S. banks show more than a fourfold increase in capital as a percentage of claims in developing countries between 1982 and 1990, to about 230 percent. A major reason for the sharp improvement in commercial banks' risk exposure to developing countries, however, has been the large-scale cutback in net lending, especially to severely indebted countries. During 1983-90, cumulative net commercial bank lending to this group was only $27 billion, compared with $206 billion net lending by official creditors, mainly bilateral sources. Viewed from both debtor and creditor perspectives, this balance of outcomes suggests that, while the debt strategy has at least been successful in preventing a major financial blowout that could have destabilized the international financial system, the results remain far from optimal. In particular, the distribution of burdens has been far from symmetric.

Very early in the formulation of the global debt strategy, three key elements were identified as indispensable to a successful resolution of the crisis: the need for debtors to implement comprehensive adjustment, the need for creditors to provide appropriate financing assistance to encourage faster adjustment and mitigate the adjustment cost, and the need to establish a favorable global economic environment to set the stage for recovery. These ingredients have been reaffirmed time and again in subsequent reviews of the strategy, and they remain valid. The continuing policy issue, however, lies in an appropriate balancing of these elements.

This balancing issue might be better appreciated from the attached summary Table 1 (see Annex), which records progress in respect of Fund programs, Paris Club agreements, and commercial bank financing agreements for the group of severely indebted low- and middle-income countries, as classified by the World Bank. A number of interesting observations are suggested. First, over 70 percent of countries already have a program in place. Compared with the situation at end-1983, this is a significantly higher coverage--33 countries versus 23 countries out of a constant total of 46. Moreover, more than half of the programs in place are the more rigorous and comprehensive extended arrangements, enhanced structural adjustment arrangements, and rights accumulation programs. Second, the 12 countries that currently do not have a program but might be judged to need one--as gleaned from the summings up of Article IV consultations--account for just over a quarter of total outstanding debt owed by the group; if Brazil were excluded, however, the credit exposure to debtors outside the ambit of Fund adjustment programs drops to just over 10 percent of total exposure to the group.

These facts strongly suggest that the adjustment component of the debt strategy is proceeding reasonably well for the large majority of indebted countries. This, of course, is subject to the qualification that mere presence of a program does not guarantee timely adjustment--though it does constitute prima facie evidence. In sum, while there is no denying the critical importance of strengthening the adjustment process in debtor countries, further significant marginal gains for those countries in the process of adjustment might best be achieved by working on other lagging elements.

Direct financial relief provided by official sources, especially bilateral sources in the form of new flows and debt relief, have been very significant. The Paris Club has also shown increasing flexibility in improving the concessionality of reschedulings, particularly to lower-income countries where debt overhang is clearly a problem. Further relief, going beyond Toronto Terms, should continue to be pursued, particularly to alleviate the increasingly desperate situation in Africa. In extending greater relief, however, the Paris Club should establish clear and transparent guidelines, which should be consistently applied and based on need and equity considerations rather than arbitrary geopolitical determinations. Otherwise, the case-by-case approach will increasingly lose credibility.

Commercial bank creditors have managed to avoid a reasonable share of the financing burden. This is evident from the relatively small number of financing packages that have been completed since 1989--only 10 out of 46 severely indebted countries have benefitted. There would appear to be two concrete ways of strengthening commercial creditor participation, without in any way weakening their financial position or rejuvenating systemic difficulties. First, there is an urgent need to remove all artificial restrictions, particularly segmentation of enhancements, which hinders debt and debt-service reduction operations in respect of commercial bank debt. There is also need to resist prescribing specific transactional elements, such as contingency clauses. These may be well intentioned, inasmuch as they purport to help a debtor in getting a better deal, but they generally act to delay negotiations or lead to higher transactional cost. It would seem sufficient that international financial institutions and donors protect their interest through overall control of access to their resources and through the right of independent review of the soundness of the transaction. Second, international financial institutions should be ready to provide, at the request of members, pertinent economic information to private creditors. This would help facilitate improved judgments by the market and thus reward the countries that pursue sound economic adjustment with better terms on their respective financing packages.

The final element in the debt strategy is the establishment of a more favorable external economic environment. There are two aspects of particular interest to debtor countries. First, is the need for a balanced and well-coordinated financial policy mix in industrial countries to ensure moderate interest rates and reasonably stable exchange rates. Second, is the need to maximize trade opportunities by mustering the political will to liberalize trade in the context of the Uruguay Round. These are elements that have already been emphasized in earlier discussions, but they offer benefits to all countries--including the indebted counties--that go immeasurably beyond the benefits that might accrue from further fine-tuning of the debt strategy itself.

As something of a footnote, though no less important for that, developments in the U.S.S.R. and Eastern Europe need to be monitored carefully and need to progress with a view to avoiding a rekindling of the debt crisis. Here, there is need to ensure that geopolitical concerns do not lead to a different approach to the balance of financing and economic adjustment--and for a sharing of the adjustment between debtor and creditor countries. As has been emphasized for the debtor countries that have travelled this path before, comprehensive economic adjustment is imperative to providing a lasting solution to problems of external viability. In that regard, I would echo the comment in the staff paper to the effect that policies must be such as to "...result in external financing needs that remain within sustainable limits and are compatible with the availability of funds."

Mr. Prader made the following statement:

Judging from the intensity of the Fund Board's debates on debt issues in recent months, the problem of developing country indebtedness is very much alive. The problem is still as urgent today as when the "crisis" first erupted. At that time, it posed an immediate threat to the international financial system; the urgency of the problem now is due to the difficulty for the indebted countries to continue their adjustment effort unless they are able to obtain a decisive improvement of their debt situation. Now that there exists an opportunity for debtors to regain a viable external position and spontaneous market financing and for creditors to improve the value of their claims, it is somewhat worrisome that the private markets are much less interested in the debt problem than they were a few years ago. This does not mean that the problem has disappeared; it has simply lost its urgency for the commercial banks, as they drastically reduced, over recent years, their exposure to the indebted countries.

Since the end of the 1980s, substantial progress has been made in negotiating approaches for helping countries with debt-service problems. A number of rescheduling arrangements, with both official and commercial creditors, have been concluded. During the same period, however, an increasing share of the new financing for indebted countries has fallen to official creditors, who have thus come to hold a larger share of the total stock of debt. Are official creditors and the Bretton Woods institutions simply replacing private lenders, or does the special nature of the present transition period temporarily require a larger role for official financing? The enlargement of official participation in development financing for the indebted countries is not a cause for concern as such. By itself, however, official assistance can neither restore the long-run external viability of the indebted countries nor replace indefinitely normal access to the financial markets. For many indebted countries, the impossibility of such access has so far put the prospect of long-term external viability beyond their reach, thus threatening to discourage their commitment to the adjustment effort.

Can we be sure that private markets will ultimately resume a larger role, once the indebted countries have made further institutional and policy changes? The lending behavior of the commercial banks so far has been rational enough from their viewpoint: by refusing to make further loans to large debtors that have trouble servicing their debt, or by offering them only unfavorable terms, the banks have only been trying to protect the value of their loan portfolios. In many developing countries, prospective investors see high risks stemming from future political and economic events, financial instability, inadequate infrastructure, transfer risk, or sovereign risk. Too much risk drastically reduces a country's chance of attracting private capital on affordable terms in the amounts needed to improve its growth and export performance and, thus, its debt indicators. The prudent conduct of domestic macroeconomic policy is thus closely related to a country's ability to service its external debt. 1/ Recent empirical evidence shows that sound macroeconomic policies can elicit positive market responses. Indeed, several countries launching far-reaching structural reforms, such as Chile and Mexico, have regained partial access to the international financial markets. Their example should encourage other indebted countries to follow a similar course. The benefits, in terms of both larger inflows of external financing and better lending conditions, are additional to the benefits of the domestic reform itself.

Today, the international banks must lend more conservatively to meet higher capital adequacy standards set by the Bank for International Settlements and stricter regulatory conditions set by governments, and many of them are weathering their own financial difficulties as well. Under these kinds of market conditions, not all debtors that pursue sound adjustment policies will thereby be able to obtain timely market financing. However,

1/ P.E. Guidotti, M.S. Kumar, "Domestic Public Debt of Externally Indebted Countries." IMF Occasional Paper No. 80.

these limitations affecting banks in general are not the only factors operating to weaken the link between the pursuit of prudent macroeconomic policies and capital inflows. Two broad categories of market imperfections or failures can also be identified.

The first type of imperfection occurs in conjunction with so-called debt overhang. Excessive levels of indebtedness may eventually discourage a country from completing its necessary adjustment efforts, and creditors that recognize this risk are reluctant to continue lending. The expectations that a heavy debt-service burden will emerge from an excessive level of existing debt stock immediately depresses both consumption and investment and leads later on to lower growth and impaired future debt service capacity. 1/ The lack of adequate coordinated and concessional assistance from private or official creditors can easily push a debtor country into such a vicious circle, and additional action is needed from the international financial community to guard against such outcomes. The Paris Club's recent moves toward debt forgiveness and debt rescheduling, and the guidelines for financial assistance in debt reduction that the Fund adopted at the suggestion of the Interim Committee in 1989, can be seen as first steps in this direction, but further initiatives will be needed, as was explicitly acknowledged at the G-7's London meeting in July 1991. As it is difficult to quantify the relationships between the reduction of debt and the behavior of other variables in the economy, further research is needed on a more precise method of determining the optimal degree of debt reduction for a given country. In such cases as the African countries, whose debt indicators are already alarming, as revealed in the recent world economic outlook paper (EBS/91/146, 8/30/91), it would be useful to determine just how much debt relief in addition to the Toronto Terms is needed to keep their debt problems from becoming unmanageable.

The second type of market imperfection occurs when the markets' response to a country's policy improvements is too slow because the markets fail to see that the improvements represent a fundamental break with a previous record of bad policies. These delays needlessly increase the risk of a policy reversal and impair the effectiveness of prior official assistance. This lagged response of the financial markets to changing conditions in countries seeking loans, together with market imperfections that impede adjustment financing, fully justifies a deeper involvement

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1/ An analytical discussion of this problem is presented in W. Max Corden, "Debt Relief and Adjustment Incentives," reprinted in J. A. Frenkel, M. P. Dooley, and P. Wickham (eds.), Analytical Issues in Debt, IMF 1989, pp. 242-257.

in the debt strategy by official creditors and international organizations like the Fund and the World Bank.

All attempts to correct market imperfections must, since they necessarily involve some interference with market forces, be formulated carefully and implemented to avoid creating new and even greater distortions.

In connection with the problem of debt overhang, the Fund must focus on three policy issues: (i) the trade-offs for the indebted countries of the costs and benefits of pursuing sound economic policies; (ii) the so-called moral hazard risk that countries will delay their adjustment in order to obtain significant debt relief; and (iii) the so-called free rider strategy of commercial banks that deliberately postpone their participation until after official creditors have taken action.

To address the problem of the markets' inadequate evaluation of countries' commitment to sound policies, the Fund should help to improve the quality of the information currently available to the markets and to promote its efficient use.

Turning first to the balance of costs and benefits for countries willing to adjust, it is important for countries to understand that, as noted on page 6 of the staff paper, adjustment is the first step on the road to better domestic performance, and that the goal of adjustment is to produce tangible benefits in terms of better living standards in addition to creating resources to service external debt obligations. It is especially important to demonstrate this for the small group of middle- and low-income countries that have so far continuously met their debt-service obligations while sacrificing present consumption and investment. Their authorities, who at times have had to resist strong domestic pressures to default on debt repayments, may consider themselves unfairly treated in comparison with countries that made much weaker efforts to service their debt. The international financial markets must receive from the international institutions the strongest possible signals that they support this group of sacrificing countries and that they wish to stress the validity of their policy conduct. By the same token, it is necessary to convince those countries that have so far shown no willingness to adjust that it is in their best interest to change their policy conduct. Even though a consensus may already exist that debt reduction is needed for a country to improve its macroeconomic performance, this proposition should rest on a more solid analytical foundation. We do not agree with the staff that "tentative and illustrative conclusions regarding the relationship between debt reduction and other economic variables" are the most that can be expected from research in this field. The Fund has a crucial role in establishing a more solid basis for policy advice on the favorable effect to be expected from a given magnitude of debt rescheduling on the growth and living standard in a developing country. Such policy advice would greatly assist the activities of the Paris Club. For example, if the amount of debt reduction that is optimal for a given country is greater than its stock of debt incurred before the cutoff date, the cutoff date should no longer be a binding constraint.

Of course, there is no automatic guarantee that debt reduction and similar forms of assistance to the indebted countries will provide sufficient incentives to adopt sound macroeconomic policies and make stronger adjustment efforts. As long as a country can influence the conditions that make it eligible for concessional assistance, moral hazard cannot be excluded and the need for caution is great. In fact, an indebted country always faces two options: it can either pursue sound policies while fulfilling all its debt obligations, or it can fail to do so in the expectation that its worsening debt problems will eventually create a strong case for concessional assistance or debt forgiveness. It has been demonstrated theoretically that there is no way of guaranteeing that a country will not choose the second alternative. Thus, it may sometimes be in the creditors' interest to provide enough debt relief to reduce the attractiveness to the debtor of the default option. 1/ To give creditors some control over the debtor's performance, debt reduction can be staged conditionally, by giving some reduction at the outset and granting the remainder only after certain criteria are met. This method has already been used in the cases of Poland and Egypt.

The risk of free riding by private creditors can be eliminated at least partly by wider use of the concerted approach to debt management. This approach also gives the official creditors stronger bargaining power in their negotiations with the debtor countries, and it establishes a positive synergism between the actions of official and private creditors. For example, the seniority status of official claims is protected in countries where official creditors have little exposure. As their claims are protected, official creditors could be more willing to increase their exposure in order to encourage private creditors to do likewise. 2/ Moreover, the effectiveness of new financing provided by official creditors to indebted countries decisively addressing their problems is needlessly undermined by the failure of private creditors to follow suit. These problems challenge the Fund to make concerted approaches by both official and private creditors a standard practice in their dealings with debtor

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1/ W. Max Corden, op. cit.

2/ See "Analytical Issues in Burden Sharing" (EBS/91/56, 3/29/91).

countries. Another drawback to the absence of concerted action arises from the effect of official creditors' actions on the market value of private debt. Unilateral assistance from official creditors causes this value to rise, creating a counterproductive incentive for private creditors to delay debt rescheduling operations. It would be an unwelcome outcome if the private creditors decided to assist indebted countries only in cases in which the official creditors have already implicitly bailed them out. Peru offers a fairly clear example of this.

Fund policies aimed at helping indebted countries regain external viability cannot succeed unless they bring about a restoration of confidence in the form of increased financial inflows. There are no reliable and systematically available indicators of an indebted country's successful re-entry into the international capital markets--or, for that matter, indicators that can confirm the renewal of confidence--which can make it hard to determine whether the markets are responding promptly and adequately to a country's adjustment efforts, although changes in the nature and cost of certain types of capital inflows do furnish useful clues to shifts in commercial creditors' confidence. In addition, it is unclear whether the current structure of the markets is competitive enough to ensure quick market responses to policy adjustments that warrant renewed confidence. In fact, almost all small- and medium-sized banks have withdrawn from this market, leaving the field to a small number of large banks. It is urgent for the Fund to obtain more information in this area.

The need for more information goes beyond securing for the Fund sufficient information about the behavior of the financial markets toward debtor countries. It is also essential to provide the markets with sufficient information about these countries' medium-term balance of payments prospects. The Fund should explain to the markets when and how they may expect countries implementing Fund programs to regain external viability. Such information would become an essential ingredient in private creditors' assessments of the creditworthiness of individual countries. More efficient use of better information will also enhance prospects for cooperation between official and private creditors, and it could lead to a more dynamic evaluation of various debt reduction options that may appear equal when evaluated statically.

It is urgent that a means be found to restore more swiftly the markets' confidence in countries pursuing sound adjustment policies for several reasons. First, it would reverse the present gradual withdrawal of private creditors from the debt situation. Second, it would protect the indebted countries from the necessity of adjusting in the far more hostile external environment that will exist if the prospective change in global supply and demand for savings drives up international real interest rates. Third, it will show the many countries currently implementing Fund programs that adjustment pays off rapidly in terms of higher income levels, as in the case of Mexico. If the private markets fail to respond quickly to the indebted countries' adjustment efforts, and if bilateral official creditors cannot take over, the Fund should step in. The obvious instrument for Fund intervention would be a conditional and temporary allocation of SDRs. Our constituency has long insisted on the usefulness of such a conditional allocation. The basis for clearly limiting the duration of such an allocation is the belief that the adjusting countries will soon attain higher income growth rates, which will increase domestic savings sufficiently to cover both future investment needs and repayment of the SDR obligations to the Fund. Such an outcome will, in turn, help demonstrate to the private markets that it is in their interest to supply financial resources to adjusting countries.

Extending his remarks, Mr. Prader commented that he greatly appreciated the independent research by Mr. Evans, which had produced interesting results. It was his understanding that the concerns expressed by Mr. Evans in his statement about the balance between financing and economic adjustment in Eastern Europe and the U.S.S.R. referred to the future and not to the present.

Mr. Evans noted that the relevant passage in his statement had, indeed, been intended to refer to the future and not the past.

Mr. Mirakhor made the following statement:

The current review of the debt situation confirms once again the appropriateness of the Fund's role and the validity of the principles underlying the debt strategy. These principles are: (i) sustained implementation of strong adjustment programs by debtor countries, including adoption of sound macroeconomic policies and supportive structural reforms designed to sustain growth recovery and to create a better environment for enhancing national savings and encouraging capital inflows, including non-debt-creating transactions; (ii) the provision by creditors of adequate financial support, including debt and debt-service reduction; and (iii) the prevalence of a supportive external economic environment. On the basis of this review, our assessment of overall developments in revitalizing the debt strategy is positive, although we are concerned that progress continues to be slow and, most importantly, uneven among the categories of debtor countries, as well as among the various participants in the strategy.

We welcome the staff's preliminary judgment regarding a faster pace of spontaneous capital market financing for those middle-income countries that have maintained strong adjustment programs and have completed market-based debt restructuring agreements with commercial banks. It should be pointed out, however, that these results are rather limited and were achieved after a difficult and protracted period of negotiations. It also needs to be emphasized, as is done in Mr. Evans's statement, that the restoration of financial credibility for some of these countries coincides with a shift in the structure of lending toward international financial institutions and away from commercial banks, which continue to avoid extending new money and still maintain a strong preference for lowering their exposure to developing countries. Therefore, we reiterate our call on commercial banks to adopt a more constructive approach in their negotiations with debtor countries, and we urge the staff to pursue the issue of how to introduce greater flexibility in graduating adjusting countries from mandatory provisioning lists.

The staff has provided the details of the support extended by official creditors to middle-income restructuring countries. The recent far-reaching debt restructuring provided to Poland and Egypt are most welcome, because, as characterized by the staff, they were aimed at providing a definitive solution to the debt problem and at avoiding future rescheduling. It is hoped that these initiatives will create a dynamic process leading to more favorable debt relief for all deserving cases.

With regard to low-income countries, while we recognize the importance of recent initiatives, the progress appears, however, to be less encouraging, particularly if viewed against the increasing uncertainties regarding the prospect of restoring growth and external viability. The increasing attention being attached to official debt, as well as the proposals for more extensive multilateral debt relief, are most welcome. However, in view of the protracted character of the difficulties faced by many low-income developing countries, we believe that meaningful debt forgiveness should be extended to those low-income countries that adhere to strong adjustment programs.

Concerning countries with continued market access, we urge the staff to continue the monitoring of the potential impact of the debt strategy on these countries. The availability and cost of external financing needed by these countries should be regularly assessed, in view of the general tightening of capital market conditions and the increasing demand on global savings. We welcome the staff's emphasis on the importance for these countries of policies in the areas of debt and reserve management, and we urge the Fund to support these recommendations by an appropriate and specific program of technical assistance.

Finally, with regard to the staff proposal to share more widely Fund assessments on some countries with participants in financial markets, we have a mixed view. On the one hand, this proposal could be helpful in enhancing the information base of the market participants about the performance and prospects of these countries. On the other hand, there is a concern that commercial banks will be tempted to request this assessment in all cases.

Mrs. Martel made the following statement:

Since the last discussion on the management of the debt situation, some important developments have occurred in the debt situation. First, significant moves have been made in the area of official debt. Second, while no new comprehensive debt reduction package has been agreed, some reduction in private debt has been made possible through a phased approach; at the same time, a resumption of spontaneous private capital inflows has been observed in a number of indebted countries. I shall reflect, in turn, on those trends and then say a few words about the Fund's involvement in the overall strategy.

This year has witnessed a significant change that concerns lower middle-income countries: for the first time, debt reduction schemes have been agreed in the framework of the Paris Club for Egypt and Poland. In the same period, I note that packages incorporating Toronto Terms have continued to be agreed in a number of cases for certain low-income countries, such as Niger, Burkina Faso, and Senegal.

While these decisions undoubtedly represent important progress in the overall strategy, some further reflection is warranted for the future. I have three remarks in that regard.

First, these are obviously only partial developments. Only Egypt and Poland have benefitted from the exceptional treatment of debt reduction for lower middle-income countries. My authorities certainly recognize the very specific reasons that led to such a treatment for those countries. These cases certainly do not constitute general precedents. Nevertheless, we also consider that other debtor countries, particularly in Africa, should be able to benefit, on a case-by-case basis, from specific treatment, to the extent that they implement with rigor and continuity financial adjustment policies in a framework of overall democratization.

As far as low-income countries are concerned, we are comforted by the fact that, in an increasing number of cases, creditor countries have opted, in the Toronto menu, in favor of concessional options, especially debt reduction, so that the average grant element is now close to 30 percent. It is nonetheless essential that Toronto treatment be improved within the framework of principles established, in particular, at the London Economic Summit. My authorities are working very hard to help reach a consensus as soon as possible in the Paris Club for implementing those principles. France is supporting a package of measures that would enable, on a case-by-case basis, a stock of debt reduction of 50-80 percent, thus obviating the need for debtor countries to request debt reduction whenever the debt falls due.

A second issue concerns the compatibility of debt reduction with the provision of new money by official creditors. Concerns have been expressed very strongly by some creditors in that regard, which have found their way into the staff paper. These are certainly legitimate concerns, which are, to a large extent, shared by my authorities. Nevertheless, the strict maintenance of the cutoff date limits, and the associated subordination of old claims to new credits, should allay those concerns. We think that, provided these indispensable safeguards are maintained, there is still some scope for official debt reduction.

The third issue, which is of growing importance, is the comparability of treatment. As the case of Poland has shown, private creditors stand to gain heavily--in terms of increases in the secondary market prices of debt--from the debt reductions implemented by official creditors. It is clear that, in the absence of similar moves by commercial banks, the whole process of debt reduction for these countries would be seriously endangered. We certainly are concerned by the tendencies described in the first two paragraphs of page 10 of EBS/91/154, according to which "there may also be an inclination on the part of banks in certain cases to delay agreement in the expectation that they may in time be in a position to capitalize on any increase in secondary market values." We would certainly not consider, as mentioned in the paper, that "in some cases, this may involve the official creditors assuming an increasing part of the financing burden and the related financial risks." I would appreciate some comment by the staff in this regard.

In passing, I note that the issue of comparability of treatment, which is not an easy one, might also be raised among public creditors in the future should some unilateral initiatives, such as debt cancellation, be linked with the granting of preferred creditor status to the remaining debt. This situation is not yet present today. One way to prevent it, however, is to stick to the guidelines defined in common by public creditors.

With respect to private debt reduction and the resumption of spontaneous capital flows, it is encouraging that, in some very important cases, debt reduction has been accompanied or followed by a significant resumption of private capital flows. This certainly validates the strategy implemented over the past two years. Obviously, the return to market access and of confidence is the result of sound macroeconomic policies, which could not have happened without a great deal of structural reforms, especially in the field of financial liberalization. However, it is also due to a favorable external environment. It is worth noting in this regard that two of the three cases cited in the staff paper as examples of a resumption of capital flows--Mexico and Venezuela--are significant net oil exporters.

In keeping with the theme of previous staff papers on the debt situation, the staff emphasizes the prospects offered by phased--as opposed to one-shot--debt reduction operations. Argentina is certainly the best example of what can be achieved by these means, once confidence has been re-established between a debtor and the banking community and with the help of innovative financial techniques. The fact that debt reduction has been accompanied by a strong and credible privatization program is certainly of great importance.

More generally, however, I have two main concerns about the information contained in the staff paper, as well as the recent world economic outlook paper (EBS/91/146, 8/30/91). My first concern relates to the number of unresolved cases, where debt reduction would be theoretically justified. The staff does not offer a specific recommendation. We certainly agree that not much can be done when an indispensable climate of confidence does not exist between a debtor and its creditors; this also strengthens, as underlined in the paper, the case for not applying in the future concessional treatment of official debt without assurances of comparability of treatment by private creditors. My second concern relates to the fact that the resumption of private capital flows has been limited, so far, to a small number of countries. Development of financial innovations can certainly have a positive impact, but only to the extent that they do not lead to permanent collateralization of future claims.

Finally on this point, it is clear that no lasting result can be achieved without the implementation of strong macroeconomic policies, based, as stated in the staff paper, on realistic pricing and exchange rate policies, together with financial liberalization. As regards the exchange rate, I point to the fact that capital repatriation in significant amounts seems incompatible with permanent uncertainty about the future path of the nominal exchange rate. It is no coincidence, in my view, that Mexico has been so successful, while, at the same time, it has established a predictable and credible exchange rate policy.

With regard to the Fund's involvement in the debt strategy, this chair broadly shares the framework outlined in the staff paper, which seems to strike the right balance between keeping in line with the previously agreed arrangement, on the one hand, and, on the other hand, offering the necessary inflections and improvements. More specifically, I would offer the following comments.

Concerning the modified policy on financing assurances, we certainly agree that medium-run viability should be assessed with regard to a set of multiple indicators, which, beyond the immediate consideration of financing gaps, would take into account prospects for future private financial flows and confidence. We certainly consider that greater emphasis on market indicators is warranted. However, consideration of secondary market prices for bank claims should be envisaged cautiously, since prices are notoriously distorted by exogenous factors and the conditions for efficient intermediation are not always met. It is also important, as stated in the paper, that sufficient time be given to countries in situations of protracted arrears to come to a satisfactory agreement with their creditor banks.

It has been the consistent opinion of this chair that there could be some advantages in increasing the degree of Fund and World Bank involvement in the process leading to a debt reduction scheme. Accordingly, we can certainly support the idea of either the Fund or the World Bank giving advice on the amount of debt reduction that would be compatible with a return to external viability and sustainable growth.

By the same token, we certainly have no difficulty with the Fund sharing its assessment of a country program, macroeconomic management, and prospects for medium-run viability with the financial markets. We would hope that this would avoid parallel discussions on Fund programs with similar discussions in the commercial banks' advisory committees on the appropriateness of the macroeconomic strategy.

We would also support the idea of introducing in debt reduction agreements more frequent and symmetric contingency clauses. This could contribute to reduce the uncertainty inherent in any market-based debt reduction scheme. This would thus enable both creditors and debtors to commit themselves to more ambitious packages.

The staff wonders whether national regulations should not be adapted so as to "graduate" a country as far as provisioning requirements for the banks are concerned. It is certainly too soon to offer a definitive position on this issue. Nevertheless, we would welcome any study or comments that the staff could produce on this interesting idea.

Finally, I could not end this statement without reminding my colleagues about the consistent position of this chair in favor of the fungibility of the resources allocated by this institution for debt and debt-service reduction operations. It seems that the staff has given up, out of exhaustion, on this idea. Nevertheless, we think that in the present circumstances--and taking into account recent experience, especially that of Venezuela--both the Fund and the debtors would benefit from a greater dose of flexibility in our financial interventions.

Mr. Esdar made the following statement:

The paper is certainly correct to emphasize the central importance of improved economic policies in debtor countries to overcome the debt problem. The world economic outlook paper (EBS/91/146, 8/30/91) illustrates clearly that countries that followed a course of prudent fiscal consolidation, noninflationary monetary policies, and structural reform succeeded in regaining growth and improving their external position. For example, in Africa--but this is certainly true for other regions as well--the economic performance of countries that have consistently implemented structural reform and stabilization policies have been significantly above average. Such policies have helped to mitigate the effects of external shocks in 1990 and 1991 and will provide the foundation for the ongoing recovery expected in the years to come. However, there is no doubt that adjustment policies have to be supported by adequate financing and restructuring, if necessary, under concessionary conditions and supplemented by debt relief. The appropriate mix of these elements has to be decided on a case-by-case basis, paying due regard to the circumstances of the particular country. As outlined in the paper, remarkable progress has been achieved in this regard in recent years in tailoring financing and rescheduling agreements to the needs of the countries involved.

With regard to the involvement of commercial banks, it is certainly disappointing that banks have become more and more reluctant to provide fresh money. In some cases, however, this may be a reaction of the less-constructive attitudes of debtor countries as well. Fund- and Bank-supported debt and debt-service reduction agreements have proven to be effective instruments. Six countries have taken advantage of this possibility to restructure their debt vis-à-vis commercial banks.

With respect to official creditors, additional concessional financing instruments have been established. Many countries, like Germany, have canceled the debt of the poorest countries. The Paris Club has adjusted its rescheduling conditions and has established concessionary terms for the developing countries. Invited by the heads of government of the Economic Summit in London, the Paris Club is discussing additional concessions for the poorest countries under the heading of the so-called Trinidad Terms.

It is true that we should be careful not to create false expectations, because this is an issue that has to be decided in the Paris Club. Nevertheless, Germany would very much appreciate it if some form of Trinidad Terms could be agreed upon by all Paris Club members as soon as possible.

As pointed out in Chart 19 of the recent world economic outlook paper (EBS/91/146, 8/30/91), the share of official assistance in overall funding has steadily increased. It would be rather unrealistic to expect that official resources could be increased infinitely. In particular, it cannot be expected that lower financing by commercial banks can be made up by official creditors. Therefore, the debtor countries should be aware that there will be an increasing competition for private, as well as official, funding. Countries with convincing economic programs have the best chance to attract external flows. There is little prospect for an increase in the flow of external savings to developing countries or a rise in domestic savings unless there is an improvement in both macroeconomic and structural policies, and if there is a supportive climate for private investment. Therefore, I can endorse the finding in the staff paper that the traditional elements of Fund-supported programs should be complemented by specific actions to foster a favorable climate for capital inflows.

Let me now turn to the other issues for discussion in the staff paper. With regard to the Fund's financing assurances policy, in my view, the relevant guidelines permit sufficient flexibility. An outright approval without financing assurances should be considered only if there is a strong program and, at the same time, it can be expected that the financing package consistent with the external viability will be agreed upon within a reasonable period of time. In this regard, market signals indicating improving financial credibility of the government may provide additional information. However, such information should not, in my view, substitute for the expectation that an agreement with the banks can be realized in a short period of time.

It is disappointing to note that, in some cases, negotiations of debtor countries with their banks have proven to be difficult and protracted. It might be difficult to assess whether such delays are caused by overdrawn demands by debtor countries or by the reluctant attitude of the banks. Therefore, as a general rule, debtor countries as well as banks should be aware that they can expect support by international institutions only if they agree on an adequate financing package. In my view, it would not be consistent with the Fund's role and its financial integrity to increase the Fund's risk by approving underfinanced programs. In such cases, the instrument of approval in principle should be considered as an alternative.

With regard to financing assurances, I would like to address another point. In the recent months, the Board has sometimes been confronted with programs in which external financial viability was more or less fragile, to say the least, and there has been an expectation that financing gaps will have to be financed by official creditors or banks. I have the impression that some of these programs have been designed to accomplish certain growth objectives and that the financing of the program was regarded as a residual concern. These suspicions have been heightened by the statement on page 6 of the staff paper that a return to satisfactory economic growth is regarded as a key element to achieve and maintain external viability. In my view, the main objective of the debt strategy should be return to external viability. This, at the same time, would be an important precondition to restore sustainable economic growth. Growth without external viability cannot be regarded as sustainable. The program, as well as the growth objective of the programs, should reflect existing financial constraints. This may require consultations with major creditors before a program is designed.

With regard to the additional issues for discussion, I can be very brief. Regarding non-Paris Club official creditors, I fully agree with the staff that their contributions are critical and that it should be expected that external claims be rescheduled on comparable terms to those agreed by the Paris Club.

There is certainly a role for the Fund, as well as the World Bank, in debt negotiations--namely, advising members with regard to the possible implications of certain options and agreements and packages. However, it should be clear that this is only an advisory role. The agreements should be the full responsibility of debtors and their banks.

Concerning the effects of provisioning requirements and the flexibility in graduating countries from mandatory provisioning lists, I have some doubts in coming to general conclusions. In the case of my country, the question of provisioning is the full responsibility of the banks themselves, and, therefore, there is certainly adequate flexibility in this regard.

I am not sure whether I understand what the staff had in mind when proposing to share the Fund's assessment more widely with participants in financial markets. First of all, attention in this regard should be given to the confidentiality guidelines. The Fund is certainly overburdened in the role of a rating agency. However, monitoring arrangements may facilitate the generation of additional external financial flows; if countries ask for such arrangements, the Fund should be prepared to accommodate such requests.

With regard to Mr. Evans's proposal to remove the segmentation of enhancements, in my view the lack of fungibility of set-aside and augmentation resources has not caused serious constraints on the agreement of debt or debt reduction packages. Therefore, we remain convinced that it is adequate to keep these two instruments separate.

Finally, I fully agree with the staff that the principle features agreed upon in 1989 for the Fund's role in the management of the debt strategy remain appropriate, and I can go along with the finding that there is no need for modifications.

Mr. Evans remarked that, although he had not done so in his introductory statement, on previous occasions he had made explicit references to instances in which segmentation had been a problem. As to the future, Directors were already well aware that the package recently negotiated in principle by the Philippines would bring the issue to the fore again. Indeed, it was his understanding that the staff was preparing a paper on the subject, which he hoped could be discussed shortly after the Annual Meetings.

Mr. Esdar noted that it was important to bear in mind that the guidelines for augmentation already provided some flexibility on a case-by-case basis.

Mr. Posthumus made the following statement:

We support the view that a continuation of the present approach to the commercial bank debt of highly indebted countries is warranted, taking into account the fact that countries that implemented a strong program and achieved a lower debt burden now have access to voluntary capital market financing again, while flight capital is returning. In order to prevent those countries from getting into difficulties again, the staff is right in emphasizing--on page 16 of the staff paper--that market re-entry or capital repatriation cannot be aimed at as a means to facilitate financing the government's deficit. Furthermore, we agree that the sole purpose of the Fund's policy to allow rising interest arrears in those cases where negotiations with banks have proven to be difficult and protracted is to protect Fund programs, while, at the same time, the country involved has to make every effort to normalize relations with creditors within a reasonable period of time.

With respect to low- and some lower-middle-income countries that are indebted mainly to official creditors, we share the staff's view that for countries that have engaged in comprehensive adjustment programs, an urgent need exists for a more definitive resolution of their debt-service difficulties. The Dutch authorities support a decision to that effect in the Paris Club.

The staff is right in saying that it is important that adequate financing be made available to countries that have implemented sound policies in the face of deteriorating economic and financial situations. Indeed, such countries may face difficulties in mobilizing planned private financing or maintaining market access. In order to improve the market assessment of these countries, the staff suggests sharing Fund assessments more widely with participants in financial markets. Sharing Fund assessments of these cases with participants in the market would, indeed, help and might be very important. However, the Fund should be very careful in formalizing the provision of information to other parties--namely, the commercial banks. It should avoid new pressures on negotiations, staff appraisals, or program reviews. It should also avoid banks from henceforth asking regularly for a stamp of approval by the Fund.

The staff states on page 3 of the staff paper that there is evidence of a continued general retrenchment of bank financing to developing countries. Although this is certainly true for bank financing to members of the Organization of Petroleum Exporting Countries (OPEC), following the war in the Middle East, as well as to African countries and some Latin American countries, owing partly to debt relief agreements, this does not hold for the developing countries in general. Bank's claims on non-OPEC developing countries expanded in the fist quarter of this year for the third consecutive quarter, which reflected primarily developments in Asia. I should like to ask the staff whether the noted retrenchment of bank financing concerns all developing countries or only countries with debt and debt-servicing difficulties. The staff is of the opinion that the provisioning against country exposures is one of the causes of this retrenchment. However, it is not clear whether the staff means actual provisions--as on page 3--or regulatory requirements--as on page 24. We agree that the regulatory requirements should not handicap the resumption of commercial bank lending to countries with a sustained improvement in their prospects. But we doubt whether the level of provisioning determines the noted retrenchment of bank financing.

Finally, I would like to raise the issue of the foreign debt of countries that fall apart, an issue that is not altogether theoretical these days. We would be interested in knowing if there is any material available on how similar situations in the past were handled. I assume that some literature, or perhaps even staff reports, might be available on this matter.

Mr. Dawson made the following statement:

The staff paper presents a useful summary of recent developments in the international debt situation. We are pleased with the progress that has been made under the international debt strategy, and we recognize the significant contribution made by the Fund in this process. We also recognize that the recent pace of activity under the debt strategy appears to have slowed, as the focus has moved to more difficult country cases. The Philippines, however, has recently concluded a second agreement in principle with its commercial banks, which emphasizes debt-service reduction and some new money. In this connection, it is important that discussions on interest arrears not unduly delay more comprehensive packages, where strong reform programs are in place. For some countries, however, emphasis must first be placed on securing essential economic reforms as a prerequisite to serious negotiations. As we have seen in the past, each set of negotiations is unique in some respects and is necessarily tailored to the individual circumstances of that country.

We welcome the recent return to voluntary access to the international capital markets by several major debtor nations that have maintained strong adjustment efforts and completed commercial bank agreements. In this regard, it is interesting to note that these countries are returning to more traditional capital market financing, such as bonds and equity--a non-debt-creating flow--as was the case prior to their large buildup in commercial bank exposure in the late 1970s and early 1980s. We note that much of this lending has, in fact, been at reduced yield spreads over bellwether instruments, a favorable sign of enhanced creditworthiness. Further action is needed, however, to open debtor economies to additional non-debt-creating flows, especially foreign direct investment. In this connection, we welcome the emphasis in the staff paper on measures to improve the investment climate as essential complements to macroeconomic and structural reforms in moving toward medium-term viability.

Appropriate domestic economic policies are, of course, critical for a country to benefit fully from the strengthened debt strategy. A case in point is Mexico, where a strong adjustment effort, coupled with debt reduction, is producing strong results: growth has increased, interest rates have declined substantially, and capital is returning.

We also strongly agree that medium-term viability reflects more than simply balance of payments viability, and that it should also be assessed in light of whether private financial flows and confidence are improving and the financial credibility of the government is being restored. Fund monitoring of improvements in market indicators in assessing viability could be useful. Two suggestions in the staff paper are, however, of concern to us. First, we disagree with the suggestion that the Fund and World Bank staff should be prepared to advise countries and creditors on ranges and broad orders of magnitude for debt reduction consistent with medium-term viability for individual countries. In our view, the Fund should not be in the business of advising on debt reduction levels. We have consistently opposed such Fund involvement in negotiations between commercial banks and debtor countries, and we do not think it would be advisable for the Fund to become involved in this way in Paris Club deliberations.

To begin with, medium-term viability is too nebulous a concept for anyone to say with certainty at what point it will be achieved. Moreover, debt reduction is not the only variable; the degree of adjustment, new financing--including grants--and debt restructuring can also vary. Picking up on a point in Mr. Evans's statement, countries' access to international markets is also a critical element in their ability to achieve medium-term viability. Particularly if the Fund took on an advocacy role, which we suspect would be hard to avoid, it would risk politicizing the Fund's role in the debt strategy. This, in turn, could lead to difficulties in securing Board approval for bank packages if they are inconsistent with staff advice.

We are also skeptical about the likelihood of broad use of symmetrical contingency clauses. Banks are unlikely to accept symmetrical responsibilities, including possible further debt reduction. Consequently, such clauses can be extremely difficult to negotiate. Indeed, in the case of Poland, creditors were unable to agree on contingency clauses.

Turning to the efforts of official creditors, the paper notes that several steps have been taken recently within the Paris Club to provide additional relief for debtor nations, including more comprehensive coverage, longer repayment terms, multiyear reschedulings, and inclusion of debt swap options. While the comprehensive debt reduction undertaken for Egypt and Poland reflected unique circumstances, the structure of the relief and the nature of options employed has provided a basis for consideration as the Paris Club reviews proposals for modifying Toronto Terms for the poorest, heavily indebted countries.

We appreciate the Fund's interest in disseminating information to counter unwarranted adverse market perceptions of a country's prospects, and in principle we believe this may be a sound concept. However, before concurring with the proposal, we would be interested in more detail on the staff's thinking: which documents might be released, how would synopses of views be prepared, and what would be the timing and manner of publication? If the staff were to disseminate such information, we would certainly want to avoid situations in which the staff became more circumspect in its descriptions of countries' circumstances and policy efforts in Board papers, lest a frank appraisal adversely affect commercial bank negotiations. In addition, the Fund may need to be prepared to release both the good and the bad report cards to avoid the perception that the unreleased report is an unfavorable assessment of the country.

In conclusion, we think the strategy continues to work well in a number of significant cases, and we look forward to working with the Fund and its membership to ensure that further progress is made.

Extending his remarks, Mr. Dawson commented that it would not surprise Directors to learn that his authorities tended to share Mr. Esdar's view on the issue of fungibility, as segmentation had not acted as a constraint on progress in the debt strategy. As was noted by Mr. Esdar, flexibility had been applied on case-by-case basis, and he doubted that the segmentation issue would have to be taken up in the near future.

Mr. Al-Tuwaijri made the following statement:

The papers before us today confirm the view that the debt strategy continues to evolve positively. While there have been no new major developments in the debt situation since our last discussion, we have witnessed the ongoing success story of the new Latin American "reformation," as well as substantial efforts by official creditors toward Egypt and Poland. The background paper prepared by the staff provides an interesting overview of the widening range of instruments and options that have emerged to resolve debt problems, to reduce the risk and costs of new debt, and to help normalize debtor-creditor relations. However, as we all know, financial engineering alone is not sufficient, and, ultimately, progress in the debt strategy will be possible only when underpinned by sound policies in debtor countries. In my remarks, I would like to focus on a number of specific issues raised by the staff.

First, there is a growing awareness that the comprehensive settlement of commercial bank debt problems is likely to take longer than foreseen. This may reflect several factors: initial expectations that were too high; weaknesses in policy implementation during the course of negotiations; or some flaw in the present debt strategy. Whatever the cause, we are now faced with the fact that, because of the protracted length of negotiations involved in completing debt packages, the Fund is likely to bear a greater burden of program financing over a longer period. Clearly, and this almost goes without saying, it is even more important that our policy on financing assurances be confined only to strong programs. However, as experience has shown, even strong and successfully implemented programs are not immune from protracted debt negotiations. In these cases, we will be faced by some difficult choices on the appropriate level of access to Fund resources.

The staff has suggested an interesting way that may enable the Fund to better assure the revolving character of its resources and, thereby, its credibility. It is proposed that we pay greater and more explicit attention to financial market indicators in order to improve our assessment of prospects in countries seeking financial support from the Fund. This would provide us with supplementary information on the markets' perception of a country's prospects, as well as the willingness of the banking community to grant a country access to international credit markets. However, while this information could be helpful in cases where it is available, it should also be treated with caution. For example, secondary market prices on bank claims and yields on bond issues may reflect institutional factors in the creditor country, such as provisioning requirements, as well as economic fundamentals in the debtor country. Also, they can be very volatile in the presence of external shocks largely unrelated to the country's economic performance. In this respect, these indicators may be a better guide of the willingness of banks to lend than of the underlying viability of a country's economic and financial prospects. Of course, such information is still useful.

The staff also has suggested that, in some instances, the Fund should be more directly active in influencing the perceptions of financial markets of a country's economic performance. Specifically, the staff considers that private financing has responded too slowly to the needs of those countries that have maintained market access over time and are implementing sound adjustment programs. Accordingly, it is proposed that, in these cases, the Fund provide information that may facilitate the markets' assessment of the performance and prospects of countries implementing Fund-supported programs. This approach, I should note, has merit only where there exists an asymmetry in the information available to the Fund and the banking community. In turn, this highlights the fact that market indicators may not always be a preferred source of information.

While I can see merits in such an approach, it does raise a number of operational issues. First, in most instances, the raw data necessary to assess a country's prospects are already available to the banking community. Therefore, the additional role that the Fund could play is to alter market sentiment toward a country, which has more to do with judgments than numbers. Consequently, the ability of the Fund to alter market sentiment lies largely through making available to market participants the Board's assessments and judgments of a program. In this respect, I am not sure that we are in a position to affect market perceptions any more than we already do. The mere existence of a program, combined with the credibility of this institution, should provide a good signal to the markets. Furthermore, it would be inappropriate to provide information of the kind that would possibly lead to quality differentiation between programs. This would serve only to undermine our credibility and that of member countries' programs. Thus, on the whole, I am reluctant to support this approach, but I would be prepared to entertain any specific proposals that the staff or other speakers may have.

Mr. Wright made the following statement:

May I first say how much I welcome the important developments in the debt strategy that have occurred since our last discussion of this topic in April 1991. In particular, the realistic debt reduction packages agreed by the Paris Club for Egypt and Poland,

and the agreement of the London Summit in July 1991 on the need for substantially more concessional treatment for the debt of the very poorest countries. Now that all governments represented in the Paris Club have shown their support, in principle, for further concessions for the poorest, I very much hope that the Paris Club will be able to implement these new terms very shortly. Of course, debt relief is no easy option for the debtors. Poland, Egypt, and, indeed, any other country that eventually benefits from Trinidad Terms, will have to increase substantially the level of payments that they are actually making to their creditors. This underlines the essential point that we can never lose sight of in connection with the debt strategy, namely, the crucial importance of combining any debt relief operation with the implementation of a strong and credible economic reform program. This point sounds almost too obvious to make. It is one made in this Board, of course, repeatedly, but the staff paper and some recent cases remind us that debt reduction is not an end in itself, but is a step toward an overall improved economic performance, which will be secured only if sound policies are implemented and stuck to long beyond the initial operation.

The main benefits from debt reduction do not come from the immediate cash flow relief; they come from the removal of uncertainty about how the benefits from economic growth will be shared between debtor and creditor. Benefits also accrue from the increased confidence that overseas private investors have that future profits will not simply be taxed away in order to pay off creditors. The staff is right to highlight the importance of these incentive effects in the paper. I also note that the movement away from the traditional cash flow approach toward dealing with the adverse effects of a growing stock of debt was a main theme running through the excellent working paper on the experience of Mexico (WP/91/83, 8/31/91).

It is encouraging to read of the recent increase in spontaneous market financing for some debtor countries. Mexico is an example of a country that has successfully combined debt reduction with the implementation of a strong reform program. The aim of the debt strategy, of course, must remain the restoration of medium-term viability and, with it, the sustained access to the flow of new credit.

The Fund has an important part to play in this process, but this need not always involve financial resources. It is quite possible in some cases to imagine the Fund's assistance being confined merely to the monitoring of a program. In other cases, of course, financial support will be appropriate. Either way, however, the Fund should never be tempted to relax conditionality for fear of placing in jeopardy an incipient improvement in market sentiment, however welcome this may be. No one's interests would be served by sending false or incomplete signals to the market, which might be vitiated by subsequent developments. In other words, if a program is off track, we should acknowledge this and not accept a weakening of conditionality to get it back on track for optical reasons, however well meaning.

The staff notes that the continued financial involvement of the Fund and other official creditors is likely to involve the acceptance of an increasing part of the attendant risks. I must say, it is not clear to me that the official sector should be bearing an increasing share of the risk. While in reality this may prove to be the case, it should not become axiomatic. While we do not hesitate to support strong programs, in no circumstances should the Fund find itself pressured by users of Fund resources or other creditors into providing finance merely because private sector creditors declined to do so, particularly if this involves compromising the Fund's normal standards of prudence.

When a member faces a genuine liquidity crisis, of course, it is incumbent on the Fund to move quickly. However, in a situation in which there are protracted discussions with creditors and a continuing buildup of arrears, the problem is one of medium-term viability rather than immediate liquidity. There is no case for the Fund putting unwarranted pressure on commercial banks and debtors to conclude agreements in such circumstances. Equally, however, the Fund should not rush to place further official finance at risk until we are convinced of the commitment of the member to sustained implementation of a realistic and strong economic program that will lead to medium-term viability and a return to market access.

It is, for example, wholly inappropriate to place official funds at risk simply because an unsatisfactory program is seen to be the best that could be negotiated, or because the implementation of a commercial bank package rests on its approval. By unsatisfactory in this context, I mean either a program unacceptably weak or one that cannot be implemented. The Fund's seal of approval is a powerful instrument but one which will quickly lose credibility if too many programs were to go off track shortly after approval. This also provides at best, of course, limited benefit to the member. Given the increased risks we should, perhaps, be well advised to insist on rather more prior actions than have been required in a number of recent programs brought to this Board.

The staff's suggestion for an increased role for market indicators, such as secondary market prices, is a useful one, I think. These indicators help us to monitor how successful programs have been at restoring the confidence of the markets. They also provide valuable information in connection with burden sharing between the official and private sectors. Debt forgiveness and rescheduling by official bilateral creditors and new finance from the international financial institutions will be less effective if they simply lead to an increase in the recoverability of old commercial bank debts.

Aside from its role in providing finance, the Fund has a central role in providing advice to both debtors and creditors about the size of debt relief that is consistent with attaining medium-term viability. I recognize that this is a difficult role for the staff to play, and, given that there are no unambiguously correct answers to such questions, the staff should continue to indicate with all necessary caveats broad orders of magnitude rather than precise estimates. The staff should not, I think, feel constrained to remain silent if, in its view, a program seems to be likely to be derailed or, indeed, impossible to achieve at all because of unrealistic expectations on the part of debtors or creditors.

In this context, I would support the staff's proposal that Fund assessments should, with the approval of the member concerned, be made available to all parties to debt discussions. There is a strong case, in my view, for transparency in this area. In addition, I would strongly encourage the staff to include in all its papers on the poorest highly indebted countries projections, which, for illustrative purposes, show the effect on the program of different degrees of prospective debt reduction. The relevance of this arises from the fact that it is not possible or realistic to assume continued comprehensive reschedulings of debt into the indefinite future. This approach would help both creditors and debtors to focus their attention in coming to realistic medium-term agreements while, simultaneously, helping the Board to assess whether a program, if implemented, is likely to be fully financed. The Fund's involvement in discussions between debtors and creditors is clearly an iterative process. The Fund cannot play a decisive role as much as it can play a role of providing information. That role is, nevertheless, an important one. I understand Mr. Dawson's concerns about this, but I am more optimistic than he is about the ability of the Fund to withstand pressures to compromise its neutrality. I would also point out that Paris Club discussions are already based heavily on the Fund's assessments.

Finally, like the staff, I see a role for symmetric contingencies in some debt restructuring operations, as long as appropriate incentives remain in place to ensure that compensating policy actions are also taken following adverse external events, and that the implied marginal tax rate of a recapture clause is not too high. Such contingencies can have the effect of sharing risks more efficiently between debtors and creditors. This can be particularly important, for example, for those countries where the prospects for full repayment of external debt are tied closely to the international price of oil.

The Chairman asked Mr. Wright whether his view, in essence, was that the debt strategy--and the Fund's role therein--had developed well, but that he had some doubts about the future.

Mr. Wright remarked that he agreed with the Chairman's summary of his position. With respect primarily to middle-income countries, time had shown just how successful the debt strategy could be if it was implemented in the way in which it was envisaged. In order to maintain that momentum and to make sure that all potential benefits were realized, however, the Fund would have to remain vigilant in ensuring that it imposed the same standards in new cases that it had in previous ones.

Mr. Zoccali made the following statement:

My authorities fully agree with the three main pillars on which the debt strategy has been based, namely, the need for: (i) strong adjustment policies in indebted countries; (ii) adequate external financing; and (iii) a favorable external economic and trading environment. In this context, we welcome the fact that debt and debt-service reduction operations have become an integral part of Fund programs, contributing to the fall in risk premia and the reversal of flight capital. There is evidence, however, that, in spite of strong policy implementation in many indebted countries, progress in solving the debt problem is slow. Two main reasons are provided by the staff to explain the protracted nature of the pending negotiations with commercial banks, namely, the presence of arrears and the reluctance of commercial banks to readily enter into new agreements, for which strong urging seems in order to facilitate pending solutions. The preferential treatment of arrears, while representing a contentious point, should not delay comprehensive agreements.

The catalytic role of the Fund in dealing with enhancements is obvious. The Fund is also in a privileged position to make assessments regarding medium-term external payments viability. However, these assessments should not a priori be constrained by either the secondary market trends--for the reasons mentioned by Mrs. Martel--or the perceived availability of enhancements and domestic counterpart funds.

As the guidelines for Fund support were considered adequate in our April meeting, and no changes are being recommended now, I would emphasize only the need for flexible application, in particular with respect to the segmentation of access and timely disposition of resources for debt reduction and interest guarantees. This flexibility is essential to minimize uncertainty and to avoid creating unnecessary constraints regarding resource availability, which could also delay the already lengthy process of negotiation in concluding debt reduction packages, some of which involve arrears.

On the specific staff view of contingency clauses, I would express a note of caution regarding the impression that symmetric contingency clauses can easily be negotiated, thus reconciling debtors concerns with down-side risks and creditors concerns regarding the cost of concessions. Bargaining positions do not always accommodate symmetry, and, even if they did, difficulties remain in adequately capturing the fiscal impact of broadly defined terms of trade changes.

I would like to address now the topic of external viability expressed through the restoration of access to voluntary financial flows. It is noteworthy that the instruments involved in the recent return to voluntary market financing have mainly been bonds and equities, while commercial bank loans represented only a small portion of the new credits and a negative net resource flow. The other characteristic of this new voluntary financing is the continued use of enhancements and collateral, which, as the staff rightly points out, though producing short-term benefits by reducing the perception of country transfer risk, may actually produce potential adverse medium-term effects on liquidity management and future access on an unsecured basis.

While commercial bank retrenchment from external financing to developing countries can be related to several causes, including more stringent regulatory measures and tight market conditions, it is also an expression of the spillover effects of financial fragility in major countries. Nevertheless, as others, we share the view that "graduation" in regulatory provisions should be further explained.

This withdrawal tendency, particularly in new medium-term financing, is especially acute for those countries that have maintained their access without resorting to involuntary reschedulings. Moreover, its persistence would suggest for this segment of countries the usefulness of not only debt management techniques but also creative solutions for reducing official debt-service volatility on a case-by-case basis, as pointed out by Mr. Ismael.

On the question of official bilateral debt, some unprecedented policies of debt reduction were implemented, particularly toward Poland and Egypt, both middle-income countries. It is noteworthy that the amounts involved represent one third of the total stock of Paris Club debt of rescheduling countries. The application of debt reduction to countries with strong adjustment programs and acute financing gaps--and whose pre-cutoff-date debt to official bilateral creditors is neither small nor easily payable--seems, no doubt, an efficient alternative course of action to repeated reschedulings. I think the reduction of pre-cutoff-date debt reinforces the debt subordination principle by which post-cutoff-date debt is expected to be repaid on schedule both to Paris Club and non-Paris Club creditors.

I welcome the reference in the staff paper to the non-Paris Club creditor countries having provided major debt relief, in some cases on more favorable terms, in spite of having themselves acute external payments constraints. Given the number of countries requiring substantial debt relief, involving relatively large official debt components that are still to be resolved, the issue warrants particular attention, as it seems unlikely that many developing creditor countries, including those in Eastern Europe, can effectively be counted on to mobilize sufficient resources to provide such debt relief, as well as new credits, and simultaneously close their own financing gaps.

Another aspect of some concern is the average turnaround time to restore new flows of financing to countries that have restructured their official debts. In many cases, medium- and long-term credit and cover is the object of significant delays. This timing element becomes particularly relevant for countries that have initiated comprehensive privatization programs and are in need of financing the acquisition of new technology and capital goods to consolidate the efficiency gains resulting from private sector investment.

Finally, more widespread official development assistance debt forgiveness, and the intensification of discussions to deepen the concessionality element of the Toronto Terms in the case of low-income countries, constitute another encouraging development in managing the official debt overhang.

Mr. Fukui made the following statement:

I welcome the opportunity to discuss the management of the debt situation before the Annual Meetings in Bangkok. I also welcome the comprehensive staff paper before us. I would like to comment on three areas, namely, commercial bank debts, official debts, and the Fund's involvement in the debt strategy.

Let me start with commercial bank debts. I welcome the continued reduction in the debt stocks of Argentina, Chile, Mexico, the Philippines, and Venezuela; these countries have been decreasing their debt through debt conversion, such as debt-equity swaps. Regrettably, however, there has been no significant progress in reaching new agreements on the restructuring of commercial bank debt, except that for the Philippines, since the last review in April. I hope that more and more debtor countries will duplicate the success of these countries and reach debt restructuring agreements with commercial banks.

At this point, let me stress again the importance of the implementation of sound macroeconomic and structural policies in debtor countries. The paper depicts various ways in which debtor countries have restructured their commercial bank debts. The common ingredient is the implementation of appropriate policies. This is the prerequisite for debt restructuring. However, debt restructuring is just the beginning. In order to recover medium-term external viability, spontaneous financing from capital markets is necessary, and to regain access this market, sound macroeconomic and structural policies are required. Therefore, the implementation of adequate policies is necessary throughout the entire process.

I would note that Japan has supported debt reduction operations--for Mexico and Chile, for example--through parallel lending by the Export-Import Bank of Japan. I would like to confirm my authorities' determination to continue to support those countries that implement adjustment policies and reach agreement on debt reduction with commercial banks.

I fully agree with the staff that it is necessary for debtors and creditors to share a common view of the medium-term prospects and requirements of the debtors. I also understand the staff's view that sufficient time is needed for both parties to arrive at a common understanding and to reach agreement consistent with medium-term viability. One of the important roles of official creditors, I believe, is to catalyze and supplement private capital flows to debtor countries. In light of this role, as the staff notes, there may be scope for official creditors to supply financing to debtor countries during their negotiations with commercial banks. Having said that, I also note the possible adverse effects of such an operation. The decision of official creditors to provide money would raise the value of debt in the secondary market. This might provide commercial banks with an incentive to wait for the provision of official credit and delay concluding agreements. Also, a supply of official credit to a debtor country will relieve its difficulties temporarily and, hence, may reduce its sense of urgency to reach an agreement with commercial banks. I would appreciate the staff's comments.

Let me turn to official debt. I welcome the fact that the Paris Club reached an extraordinary agreement on debt reduction operations for Egypt and Poland this spring. I also welcome the fact that these agreements incorporate the menu approach, which enables creditors to choose one option from alternatives according to their circumstances, while maintaining fairness among creditors. It should be noted that, as the staff rightly points out, these agreements were reached because of the unique circumstances of the two countries and should be regarded as exceptional.

The Annex to the staff paper provides interesting information on the debt relief provided by non-Paris Club members. Discussion tends to focus on debt relief by the Paris Club members, not only because the Paris Club has taken the leading role in tackling the debt problem but also because we know more about Paris Club activities than those of non-Paris Club countries. As the paper notes, non-Organization for Economic Cooperation and Development countries have 25 percent of the total debt of low-income rescheduling countries, and they have extended significant debt relief to debtor countries. They are, therefore, too important to be neglected. I hope that the staff continues to gather information about them and informs us of its findings.

Let me make some comments on official debt reduction. The paper supports the supply of official new money and, especially, official debt reduction. However, I am concerned that official debt reduction has adverse effects on the supply of official new money. As the staff points out, provision of new money is important, as adjustment programs often require additional official financing. Also, new official financing is indispensable when rescheduling countries settle arrears to international financial institutions. Japan has provided a substantial amount of new money to debtor countries. However, I would note that the reduction in official debt will make it virtually impossible for the Japanese Government to provide any more official new money.

Let me turn now to the Fund's role in the debt strategy. One of the most important roles of the Fund is to help member countries design and implement adjustment policies. I share the concern of the staff that the market has insufficient information to assess the prospects of the debtor countries, and debtor countries, at times, have inadequate market access, even though they have been implementing Fund-supported programs. Supplying information about Fund appraisals to financial markets will surely improve the markets' assessment. Therefore, as long as the program country consents, I support the release by the Fund of relevant information on a member's program to private creditors. The Fund, therefore, has to maintain strong programs not only for the sake of the member countries but also in order to maintain the credibility of Fund-supported programs.

Mr. Monyake made the following statement:

The objective of the debt strategy, which is the restoration of normal debtor-creditor relations and the reduction of the debt burden in a framework that attaches priority to a return to sustained economic growth, remains appropriate.

The broad conclusion that I draw from the staff paper is that the record is mixed, and that while the strategy may be broadly appropriate, it needs a boost in the arm to improve its effectiveness. Commercial bank debt is a case in point. There are only a few successful cases--Mexico, Venezuela, Chile, and the Philippines. For other countries, progress on comprehensive debt restructuring packages with commercial banks has been quite slow, and has been even slower for low-income countries. It is also quite evident that commercial banks have continued their retrenchment from lending to developing countries, in part because of regulatory requirements. Even countries that have avoided rescheduling and have adhered to timely servicing of their debt face difficulties in mobilizing medium- and long-term commercial bank flows. Against this background, it is clear that there is much work to be done to restore spontaneous capital market access, and the Fund should continue to play the role of honest broker in getting commercial banks and debtor countries to reach agreement on debt reduction in a timely manner. Meanwhile, I support the view in the staff paper that countries that are implementing sound adjustment policies be given sufficient time to reach agreement with their bank creditors that is consistent with medium-term viability. Of course, this has implications for the Fund's policy on financing assurances, but the Fund has to be flexible in the application of this policy in order for the debt strategy to work, considering that it does not have any direct sway over the commercial banks. Another point to keep in mind is that restoring the financial credibility of governments is partly economics--and this is one of the reasons why commitment to economic reform is important--and partly psychology. The latter can lead to market failure, even when the adjustment effort is strong.

Concerning official debt, the Paris Club has made commendable progress in dealing with the debt overhang of a number of countries. Debt forgiveness is a particular case in point. However, the problem remains serious, as debt-service difficulties, in general, have not been eliminated. In the circumstances, expanding the modalities for debt relief that go beyond Toronto Terms, along the lines suggested by the United Kingdom and the Netherlands, deserves urgent attention. The agreements reached with Egypt and Poland provide an interesting background against which Paris Club creditors can advance the debate over further concessional relief. Like those two cases, the debt strategy should now seek to provide definitive relief. In some cases, this should mean further debt cancellation; in others, like some lower middle-income countries, this should mean significant reduction in the stock of debt and a repayment period that is consistent with the ability to pay.

We are pleased that the idea of rights accumulation programs for protracted cases of overdue obligations to the Fund has become a reality for two countries. We hope that other countries in arrears will participate in this process, and we would encourage the Fund and the World Bank to continue to strengthen their cooperation in assisting countries in dealing with the problem of arrears.

We believe that the guidelines for providing financial assistance for debt and debt-service reduction operations remain appropriate. The Fund should also be prepared to respond positively to members seeking advice on the level of debt reduction that would be broadly consistent with attaining external viability. Sharing information on a member country more widely with the financial markets should be handled with care; we do not want to get into the situation in which the need to hold back on some information is interpreted negatively by financial market participants.

Mr. Jamnik made the following statement:

The staff paper provides a useful overview of recent developments in the debt strategy, and we support its general thrust. Before commenting on the paper itself, and given the fact that we are looking at this issue in the context of the recent world economic outlook paper (EBS/91/146, 8/30/91), I would like to touch briefly on two themes that are relevant to discussions on international debt issues: the first theme, the responsibility of debtor countries to get their domestic economic and financial policies right, has been emphasized consistently by other speakers; the second theme, the importance of a supportive international economic environment, perhaps less so.

It would be ironic and unfortunate if severely indebted countries, having taken appropriate adjustment and structural measures and having opened up their economies to foster trade and investment flows, were to have their escape from their debt problems thwarted by the failure of industrial countries to remove trade barriers. As most Executive Directors noted during this week's discussion on the world economic outlook (EBM/91/129 and EBM/91/130, 9/23/91; and EBM/91/131 and EBM/91/132, 9/25/91), we must redouble our efforts to achieve a successful conclusion of the Uruguay round in order to reinforce progress on the debt front.

Let me make a few brief comments on recent developments under the debt strategy. We believe that substantial progress has been made in reducing the debt burden of certain severely indebted countries, whose debt is largely owed to the commercial banks. The move to more innovative financing instruments has lead to agreements that have met debtor countries' objectives and accommodated the diverse interests of the banks. This progress, however, is in stark contrast to developments for severely indebted low-income countries.

This chair has stated consistently that, for many of the poorest countries, Toronto Terms reschedulings are insufficient, in terms of both the degree of debt reduction and the level of cash-flow relief. There is a pressing need to reach early agreement on a significant enhancement of Toronto Terms and to proceed on the phased reduction of the stock of debt of eligible countries undertaking the necessary economic reforms. It is essential that creditor countries move decisively on this issue and make every effort to clear away any domestic impediments to their joining a consensus at the Paris Club for deeper concessions on the debt of the poorest.

Turning to Fund involvement in the debt strategy, let me address a few of the issues raised by the staff. The fact that the pace of concluding agreements has slowed should not be surprising, as, by and large, it has been the most promising candidates, with reasonably good track records of policy implementation, that have been quick off the mark to reach agreement with their commercial bank creditors. However, we concur that the very long gestation period of some debt agreements gives cause for concern, particularly when viewed against the background of the Fund's modified financing assurances policy. We endorse the staff's view that its application should be confined to protecting only strong programs. However, we regret that many programs are being brought to the Board in which financing assurances are tentative at best, placing the onus on official creditors, writ large, to provide higher levels of assistance and more generous debt relief in support of programs that are often less than ambitious. In such cases, we would echo Mr. Wright's assertion that we must be increasingly vigilant with respect to risks to the Fund--not only to its financial resources but also to its credibility.

On the issue of contingency clauses, the concept is appealing, perhaps even seductive. In theory, symmetric contingency clauses in debt agreements could be appropriate, given the uncertainties involved in determining the extent of debt reduction consistent with attaining viability. In practice, however, we are not convinced that such contingency clauses would be feasible or, perhaps, even desirable. We would also note that there does not appear to be much support for symmetric contingency clauses in either the banking community or the Paris Club. As noted by Mr. Dawson, in the case of Poland, official creditors examined contingency clauses, found them wanting, and chose not to include them in the agreement. Aside from the obvious problem of determining appropriate--that is, objective and quantifiable--triggers, Paris Club creditors felt that the inclusion of such clauses contradicted the notion of a definitive "exit" rescheduling, thereby undermining the very confidence that the debt reduction exercise was intended to generate.

On another issue, the staff raises the question of whether there is scope for greater flexibility in "graduating" a country from mandatory provisioning lists following evidence of a sustained improvement in its prospects. In this regard, we note that Canadian guidelines are already quite flexible and strike a balance between legitimate prudential concerns of bank supervisors and the rehabilitation of previously troubled borrowers. Under Canadian rules, a country may be graduated after only two years have elapsed following a rescheduling agreement if it can be demonstrated that, by the end of this period, the country in question has been able to raise long-term funds on international capital markets on a voluntary, unsecured basis. We would also point out that, as Canadian banks have established loan-loss provisions that are far in excess of the supervisory minimum, new lending to countries on the provisioning list would not automatically result in fresh provisions being required.

In conclusion, we do not think that there is a need for major changes in current Fund modalities. However, we would add our voice to those that suggested that Fund guidelines on the use of set-asides and additional resources for interest support may need to be re-examined. Since the development of those guidelines, menu options in agreements with the banks are evolving in ways that had not been expected. As we have always maintained that Fund resources to support debt and debt-service reduction should be used flexibly, we would favor a review of the guidelines with a view to easing unnecessary rigidities.

Mr. Jaramillo made the following statement:

The staff paper on the management of the debt situation, and the section in the world economic outlook paper (EBS/91/146, 8/30/91) on recent developments in the debt strategy, repeatedly stress the importance of macroeconomic adjustment, sound policies, and appropriate structural reforms as crucial to the solution of debt difficulties faced today by many developing countries--and rightly so. The recent progress made by some Latin American countries definitely could not have come about without these ingredients. It is important to highlight the success of these re-entrants to international capital markets, not only as a signal to other would-be participants that there are significant pay-offs to be reaped from sound economic management, but also as important experiences from which much can be learned by debtor countries.

Having said this, however, what seems worrisome is the long way that still lies ahead. It seems evident that many countries are still far from a definitive solution to their debt problem. In a way, the emphasis placed on the very positive country achievements already mentioned and the progress in other cases draws attention to the limited number of cases that may be considered to have regained some access to external finance. Consequently, attention is drawn to the many difficult cases that still remain, many of which will be very difficult to solve, while others, I believe, will be almost intractable under what have become customary arrangements.

Table 17 of the world economic outlook paper highlights how much still has to be achieved if we are to see the end of the debt problem. Let me cite a just few figures: the debt to export ratio for both the 15 heavily indebted countries and the countries with debt-servicing difficulties is more than two times the average of that for developing countries as a group. For the case of small, low- income economies, the ratio has continued to rise and is now almost three times the average. The debt-service ratio, for which more progress has been made as a result of debt-service reduction packages, is still almost twice as high in both the heavily indebted countries and the small low-income economies, compared with the average observed for all developing countries.

The world economic outlook paper places significant emphasis on what has been achieved through debt forgiveness and debt and debt-service reduction. The figures presented in Table 16 of that paper show that, for those countries that have concluded debt reduction agreements with banks, reductions have amounted to

13.7 percent of the total debt of those countries. But for countries receiving debt forgiveness under Paris Club arrangements, the ratio is 5.5 percent, and it is only 2.2 percent for countries that have been granted Toronto Terms. These numbers tell much the same story as is emphasized in the staff paper on management of the debt situation: significant progress has been made in a few selected countries. But they also tell us that for many other countries, particularly the poorest, very little has been achieved so far. In stressing these points, I wish only to insist that the debt problem is still with us and that it will remain so for some time unless decisive action is taken.

Furthermore, as was emphasized during the discussion on the world economic outlook (EBM/91/129 and EBM/91/130, 9/23/91; and EBM/91/131 and EBM/91/132, 9/25/91), capital markets will surely be tight in the coming years, reflecting the increased demand for world savings stemming from the requirements for the transformation of Eastern Europe and the U.S.S.R. Under these conditions, many indebted countries will face a particularly difficult environment. A revived debt strategy needs something more than we have today. It requires the strong political determination of the creditor countries to make the appropriate changes in domestic regulations and to support the timely action of multilateral financial institutions in facilitating mutually satisfactory agreements with creditor banks. It may also have to involve innovative approaches on the part of official creditors with respect to certain categories of countries.

One year ago, when the debt strategy was reviewed, three countries had reached agreement with their creditors for debt and debt-service reduction packages. On this occasion, another three countries have done so. This slow pace is illustrative of the lengthy negotiations and of the problems involved. Even debtors that have maintained their debt-service records intact and that have been pursuing sensible economic policies have had to face very lengthy negotiations to obtain new credits.

Unfortunately, little is included in the present strategy to, as the staff puts it, "ensure that all countries adopting the required adjustment those countries that adopt adequate adjustment measures do not see their development prospects constrained by lack of private credit." The suggestions made by the staff regarding "graduating" a country from mandatory provisions is certainly an idea that ought to be pursued further. Ways to improve the markets' and regulatory authorities' perceptions of debtor country prospects should be enhanced. Nevertheless, in our view, Fund documentation should not be circulated without case-by-case approval by the Board and consent by the countries involved.

According to the staff papers, in low-income countries, progress is highly visible for those that have embarked on structural adjustment arrangements or enhanced structural adjustment arrangements. But, as is also pointed out, in many cases the situations are so fragile that the achievements obtained could easily be reversed even by small policy slippages or adverse external developments. In this context, Table 18 of the world economic outlook paper is quite impressive in showing that small, low-income countries obtained $1 billion in debt relief over 1986-1990, while they had to increase their net debt by $47 billion over the same period; the corresponding figures for sub-Saharan Africa are $1.2 billion and $35.7 billion. I would appreciate it if the staff could comment on these figures, which may be overestimating the problem by not considering the grant element of many of the new loans. Even taking this element into consideration, however, it seems obvious, as the G-7 have recently recognized, that relief beyond Toronto Terms will have to be considered seriously for many low-income countries. The U.S. Initiative for the Americas is a very welcome development in this respect.

The cases of Poland and Egypt have been described as special and unique. By implication, the terms given in those cases cannot be extended to other borrowers. Nevertheless it is noteworthy that the basic criterion that prevailed in these two cases, apart from the special status of the countries, was that the reductions in the stock of debt was to provide a definitive resolution of their debt-service difficulties. Together with appropriate macroeconomic and structural policies, this would pave the way toward medium-term external viability and growth. One cannot but ask whether terms similar or even more generous than those provided to Poland and Egypt will not have to be granted, sooner or later, to other debtors, provided there is a commensurate commitment from the beneficiaries to comprehensive adjustment programs. The criterion would be the same: to solve, once and for all, the limits to external viability and growth posed by unmanageable debt burdens. Certain middle-income countries might also need concessions along these lines, as the recent discussions between Peru and its official creditors have highlighted. One of the countries in our constituency took part in the very encouraging consensus to reduce Poland's debt. It is logical and certainly desirable to extend the treatment of Poland's official debt to other middle-income countries.

We learned with great interest Mr. Ismael's suggestions for providing some sort of relief to debtors that have limited possibilities for debt reduction because of their past reliance on official credit, particularly that of multilateral institutions. The first of Mr. Ismael's proposals is, in a way, along the lines suggested by the staff in its reference to the use of contingency clauses in dealings with commercial banks, although in a diluted fashion that could make it more acceptable to official creditors. The second of Mr. Ismael's proposals could be explored through some form of IFC participation. Finally, the importance of the suggestion about finding ways to even out the effects of exchange rate fluctuations can be highlighted by referring again to Table 18 of the world economic outlook paper, which shows that increases in debt stocks resulting from valuation adjustments are of comparable magnitude to net borrowing figures.

The background paper on private sector international lending provides an interesting and instructive section on capital repatriation. I agree with the views presented therein, as they describe quite precisely what in fact has happened in those countries that have been able to create the environment amenable to private capital inflows. Nevertheless, I was struck by the total absence of any word on the problems associated with this process. I understand, of course, that in a paper on debt problems, capital repatriation must be seen in a very favorable manner; after all, it is, in a way, a nonproblem. Furthermore, it is an appealing solution. Nevertheless, it may create difficulties of its own, as certain Latin American countries have experienced in the recent past. The importance of capital repatriation in helping to solve the debt problem in many countries is enormous. For this reason, it should be studied in all its angles. It would be interesting if the staff could analyze the drawbacks involved, and their probable solutions, as this chair has suggested before when discussing particular country matters. I am sure this could eventually avoid many pitfalls.

Mr. Fridriksson made the following statement:

The debt situation continues to be a mixed bag. A welcome recent development is the regained access of some Latin American countries to spontaneous capital market financing. They are beginning to reap the fruit of effective adjustment policies formulated within the framework of the overall debt strategy. Noteworthy events since our last review are the Paris Club agreements for Poland and Egypt.

At the same time, it is disappointing that there has been little progress in the relations between indebted countries and their commercial bank creditors on debt restructuring packages, and that some heavily indebted countries have yet to come firmly to grips with their economic difficulties. Progress among official creditors in dealing with the external debt problems of low-income countries has also been painstakingly slow, and some countries, which have avoided reschedulings, continue to encounter difficulties in credit markets.

In general, we can endorse the staff's views and agree that no modifications to the guidelines for Fund support of the debt strategy are needed at this stage. Let me touch on some of the issues raised by the staff, although I will not necessarily address all those suggested for discussion.

The papers tell us that new bank lending to low-income countries has been stagnant since the mid-1980s, with the small recorded increase being mostly explained by an increase in interest arrears. The papers list several likely explanations for the slow pace of negotiations between indebted countries and the banks, and for the banks' apparent foot-dragging in finalizing agreements on debt reduction operations. My authorities are concerned that this development has resulted in an increasing share for the Fund and other official creditors in providing external finance to indebted developing countries. Unfortunately, it seems unrealistic to expect sudden changes in this area, and we would, therefore, support efforts to speed up and increase the participation of commercial creditors, both in terms of debt reduction operations and in the provision of new finance.

Many countries continue to face immense external debt burdens, which are of such proportions that they cannot be alleviated through adjustment policies or conventional rescheduling. Much more is needed, and, without drastic debt relief, medium-term viability cannot be achieved. We have seen cases before the Board recently that show a ballooning financing need after rescheduled obligations become due, which, in the absence of large-scale debt relief, leaves the countries concerned in a rather hopeless situation and the Fund and other responsible players in the debt strategy entangled in holding operations.

Nevertheless, the Fund continues to play an important role in the debt strategy in helping to normalize debtor-creditor relations. The major responsibility continues, of course, to lie with the indebted countries themselves. The Fund's most important contribution is in helping to design effective and comprehensive adjustment programs.

For countries returning to spontaneous market financing, it is important to move carefully. Credibility can be very fragile. The papers note the relatively short maturities on newly contracted debt, which means that the debt will have to rolled over more frequently than otherwise. Continued improved access to market financing is, therefore, of the essence. At the same time, it will be important for the borrowing countries to employ risk management techniques in order to reduce their vulnerability to exogenous developments. I wonder whether the staff can inform us as to whether technical assistance in the field of debt management is being provided by the World Bank or other agencies with expertise in the field.

We have repeatedly emphasized the importance my authorities attach to the policy on financing assurances. The resources of the Fund must not be left to luck. We concede that in some instances the early involvement of the Fund provides the only possibility of generating the necessary subsequent assistance from others, particularly in countries that have had difficulty reaching agreements with their commercial creditors. Some flexibility may be unavoidable, particularly as regards expected debt reduction packages with the banks, but in these cases the countries concerned must have both a strong adjustment program and a good track record of policy implementation. In our view, some recently approved programs did not meet these criteria. My authorities would, therefore, wish to once again urge adherence to the policy on financing assurances, particularly when there is considerable uncertainty regarding medium-term external viability and the capacity to repay the Fund.

In discussing the agreements with commercial banks, the paper appears to be somewhat too liberal. If I may quote: "...the most effective approach appears to be to give the country sufficient time to reach an agreement that is consistent with medium-term viability, and to facilitate the process whereby all parties converge toward a sufficiently common view of the medium-term prospects and requirements of the country." Then it is said that, during this process, official creditors may have to assume an increasing part of the financing burden and the related risks. We miss an element of urgency in this scenario. Once ambitious adjustment is under way, it is critically important to maintain momentum, which is difficult if the process holds little prospect of becoming viable. In this respect, I agree with Mr. Wright's comment on the importance of removing the uncertainty caused by an unsustainable debt situation.

We have no difficulty with the Fund being responsive to members' requests for assistance in debt reduction calculations, as suggested by the staff paper. However, the paper also raises the issue of whether financial market participants could be helped in evaluating a country's performance by having access to Fund assessments of individual countries. If the staff has in mind something beyond the procedures under the enhanced surveillance process, there is a risk that the confidentiality of Fund consultations may be compromised, thereby possibly complicating the gathering of information. This point must, therefore, be more carefully examined by the Board.

Finally, a word on the role of official creditors. My authorities welcome the progress made within the Paris Club in recent years in dealing with difficult debt problems. The Paris Club has a full agenda for the period ahead. My authorities are particularly concerned about the problems facing many sub-Saharan countries. Their adjustment efforts must be complemented by comprehensive debt relief if medium-term viability is to be achieved. It is necessary to go beyond Toronto Terms for those countries, and my authorities are very disappointed that an agreement on new terms has not yet been reached in the Paris Club. Hopefully, the delay will not last much longer. At the same time, it will be very important that non-Paris Club creditors match the terms offered by the Paris Club if the strategy is to bring debt-ridden countries back to viability.

Mr. Sarr made the following statement:

From the excellent papers prepared by the staff for our review of the debt strategy, it appears that the major challenge facing us at this juncture in the implementation of the debt strategy is how to address the loss of momentum by commercial banks in addressing the remaining important debt cases and how to revive their interest, thus ensuring that the high hopes raised by this strategy when it was first put in place can still be fulfilled.

As indicated in the papers, despite the improved stance in economic and financial policies in debtor countries under programs supported by the Fund, no new agreement with commercial banks has been put in place since our last review. Also, capital market access for countries that have already concluded commercial bank agreements is still extremely limited. In addition, the low- and middle-income countries that did not experience debt-servicing difficulties and maintained an exemplary debt-servicing record are now facing difficulties in mobilizing medium- and long-term financing.

All of these developments bear testimony to an alarming trend in our debt strategy, which does not augur well for a number of difficult cases that still remain to be addressed.

We welcome the staff's analysis of the various reasons behind this situation. Noteworthy is the recognition that, while the slow progress in implementing adjustment programs and in solving the problems of arrears to banks has played a part in some limited cases, this situation is arising also from factors not related to the willingness of debtor countries to continue with their adjustment process. It is further recognized that developments in the tax and regulatory environment of creditor countries have also played a role.

We agree with the staff that normalization of relations with creditors and the revival of financial flows should remain key objectives in monitoring performance and in assessing viability of the debt strategy. In this regard, while we welcome the information provided in the background paper on relations between commercial banks and low-income countries, in view of the rapidly changing market conditions, the staff will need to continue to improve the reliability and comprehensiveness of its information on terms and conditions of private market financing, especially for low- and lower medium-income countries.

While the market-based approach to debt and debt-service reduction operations remains flexible and sufficiently broad to accommodate various country circumstances, we nevertheless find disturbing some of the underlying difficulties that countries are facing in the process of returning to normal financial relations with their creditors. These difficulties include the following: the shift in the composition of financing toward shorter maturities; the tightening of loan conditions for a number of lower-income countries for their short-term trade loans; the extensive use of enhancements and collateralization; and, finally, the sometimes unreliable market perception of creditworthiness of some countries and the delays in correcting this perception. All of these trends can not only increase borrowers' vulnerability to exogenous shocks and their flexibility for future borrowing but also contribute to a withdrawal of medium-term financing and, thus, undermine the adjustment efforts of many creditworthy countries.

In contrast with private debt, interesting developments occurred with respect to official bilateral debt since our last review. A number of important debt cases were examined, and exceptional and far-reaching terms of rescheduling encompassing reduction of stock of debt and debt-service were accorded. Moreover, the menu of options continued to be adapted to the particular economic circumstances of each debtor, and repayment schedules have been tailored to the cash flow requirements and to the medium-term repayment capacity of debtor countries. We also welcome the increase in the number of creditors engaged in the forgiveness of official development assistance and the increased debt relief provided by non-Paris Club official creditors during this period. We have noted in particular the generous terms provided by other developing countries, which, in a specific case, have reduced the net present value of debt by some 90 percent. Moreover, financing from multilateral regional institutions, as well as international and relief organizations, became available in support of debt and debt-service reduction, thereby contributing to the widening of official support for debt reduction. Finally, the number of innovative practices introduced recently has allowed bilateral financial institutions to maintain the level of their new money.

However, despite these positive and welcome developments, the debt burden for many low- and lower middle-income countries heavily indebted to official creditors continues to be unbearable. We regret that a number of proposals put forward to address the debt problem have not yet become effective. We welcome the indications by Mrs. Martel and other Directors that their authorities are working within the Paris Club with a sense of urgency on the development of a consensus on this issue. We hope that other Paris Club members will also facilitate an early agreement on this important issue.

Turning now to some specific issues raised by the main staff paper on the nature of the Fund's involvement in the debt strategy, we agree that, in view of the likely protracted nature of the negotiations with commercial banks, our modified financing assurances policy has allowed indebted countries to maintain the thrust of their adjustment effort while finalizing their discussions with private creditors. The circumstances in which arrears have been tolerated on a temporary basis are still adequate, and we do not see any reason to alter our approach on this issue.

We endorse the staff's view that, in some cases, the Fund would need to broaden the range of indicators of medium-term viability so as to include market indicators. However, these market indicators should not be a substitute for the Fund's traditional analytical approach for assessing medium-term viability. We continue to believe that the Fund's involvement in the form of assessment of quantitative medium-term scenarios and assistance in the analysis of proposals made by banks could improve the environment of the negotiations and result in improving the timing, as well as the appropriateness, of the financing packages. We recognize the difficulties associated with this exercise, and we see merit in the careful assessment of the debt reduction that could be compatible with medium-term viability. At the same time, both parties should be encouraged to adopt symmetrical contingency schemes in future financing packages.

In view of the impact that a rapid shift in market sentiment can have on market borrowers that have avoided rescheduling, we agree that measures to support and attract non-debt-creating flows should be addressed and encouraged in these countries. Also, subject to the countries' approval, we have no difficulties with the Fund sharing more widely its assessments with participants in financial markets. We also agree with the staff that there is a need to improve the flexibility and harmonization of provisioning regulations among creditor countries, and we encourage the Fund to continue to monitor changes in the tax and regulatory environment that will help to fulfill the overall objectives of the strengthened debt strategy.

The Deputy Managing Director assumed the chair.

Mr. Kyriazidis made the following statement:

The staff paper points to two main conclusions regarding developments in the debt situation since our last discussion. First, there has been no significant progress in commercial debt restructuring, and the process will continue to be very slow and protracted. Second, the official sector has continued to enhance its role in the debt strategy and is further continuing discussions in the direction indicated in the G-7 communiqué, particularly with regard to low- and middle-income countries. Furthermore, official creditors outside the Paris Club have continued to offer terms in many cases better than those of the Paris Club to their debtors. This skewed distribution of effort, particularly in the light of the evidence of continuing withdrawal of the commercial banks from sovereign lending, should be a cause for concern.

The staff proposes a number of questions in the light of the present picture. I will try to answer some of them in the order in which they are presented. First, there is no doubt that, in cases of weak policy implementation, progress in resolving debt difficulties is inevitably slow. The timely introduction and implementation of appropriate policies, particularly where exceptional support will be required for medium-term viability, is a fundamental prerequisite for progress.

The staff seems to suggest that strong Fund-supported programs need to be complemented by specific actions to foster non-debt-creating private flows. The development of such flows on a sustained basis, including major debt-equity conversions, depends on structural reform in addition to the sustained achievement of macroeconomic balance. I would agree, therefore, with Mr. Ismael that this implies a shift of emphasis toward multiyear programs of reform under the guidance of both the Fund and the

World Bank, in tandem, with strong short-term adjustment policies designed to address internal and external imbalances. To the extent that this might lead to protracted Fund involvement with increased risks, however, it would be incompatible with the monetary character of this institution.

Second, I note that the staff has a rather pessimistic view of the preparedness of the banks to undertake comprehensive settlement of debt problems, even in cases in which economic reforms are being pursued in a sustained fashion. This is a particularly serious problem with regard to low-income and smaller middle-income countries. I would agree with the staff that, if the debtor country sustains its policy efforts, it is important that it be given sufficient time to reach an agreement with its bank creditors that is consistent with medium-term viability. As this has serious implications for official creditors, including international financial institutions, I would like to ask the staff what presently leads commercial banks to resist comprehensive or phased operations. In particular, I would like to know whether there could be conditions in which banks might be more willing to agree to comprehensive or phased restructuring operations.

Third, the staff rightly indicates that the protracted nature of the process of bank debt renegotiations has implications for the application of the Fund's financing assurances policy, as it increases--even in the case of strong programs--the financial burden and the attendant risks borne by the Fund and other official creditors. This would appear to indicate the need for a reconsideration of our financing assurances policy, including, perhaps, a shift back to the approval in principle procedure.

Fourth, I would agree that in order to facilitate the return of confidence and the improvement in the climate for negotiations, market indicators, such as secondary market prices for bank claims and yields on bond issues, should be factored into the assessment of performance and viability. However, as markets are thin and somewhat volatile in response to short-term developments, the usefulness of such a procedure is rather limited. It would also be helpful if there were some greater flexibility in graduating a country from mandatory provisioning lists following an eventual sustained improvement in its performance and prospects. I would also be positively inclined, although, again I can see limited gains from this, toward the idea of sharing Fund assessments more widely with participants in financial markets, with the approval of the member concerned, so as to facilitate the market in appropriately rating countries implementing sound policies.

Fifth, I would also agree with the Fund staff providing advice if so requested, with the appropriate caveats, on the amount of negotiated debt reduction consistent with viability, as proposed in the staff paper. I would also agree with the inclusion of symmetrical contingency clauses in debt reduction agreements with commercial banks.

Finally, official creditors, including international financial institutions, have enhanced their role in the debt strategy. They will continue to pursue this action on a case-by-case basis, but they are carrying a disproportionately large burden. We should, therefore, explore thoroughly all appropriate means of action that can help in speeding up the process of bank debt renegotiation.

Mr. Torres made the following statement:

Notwithstanding the slow pace of progress observed recently, it is worthwhile to note that much has been achieved since the implementation of the debt strategy in 1989. As a result, several heavily indebted middle-income countries have reduced their commercial bank debt to what seems to be a manageable level, and some of them are starting to show signs of substantial progress, not only in the difficult task of returning to a path of sustainable growth but also in being able to confront the lengthy process and difficult obstacles of returning to voluntary financing in the international capital market. It is regrettable, however, that nearly six months have passed since the previous review of the debt situation, and no new agreements have been reached between indebted countries and their commercial banks. Moreover, even if a couple of agreements could be reached in the remainder of the year, their number during 1991 would still be lower than that in any year during the past decade.

Unfortunately, for many countries, the debt situation has not improved and the debt overhang continues to impose a tremendous obstacle to growth and external viability.

The staff papers pay particular attention to the experience of some of the countries in my constituency, in particular the cases of Mexico and Venezuela. In this regard, I would like to make some remarks on a few of the issues related to the re-entry of these countries to international capital markets, as a way of clarifying and underlining the key role played by expectations in this re-entry and in the management of debt in general.

The first remark concerns the inevitable trade-off that arises in a negotiation between the objectives of reaching an agreement and achieving a large debt discount. Striving to maximize the debt discount may prove to be a costly process and may unnecessarily delay the achievement of a viable agreement that can be honored by the debtor country. By affecting expectations, i.e., a viable debt agreement--notwithstanding the difficulties of defining viability in this context--may have significant and positive indirect effects, as long as the debt negotiation is complemented with sound and lasting economic policies. This point has been made very well by one of my authorities: "...a comprehensive agreement that puts to rest any fears regarding possible future renegotiations is even more important than achieving a large discount on the debt. The deal must be such that economic agents cease bringing up external debt as a topic of discussion, i.e., 'permanency' must be established."

The second point has to do with the reduction of exposure to undesirable changes in exogenous key prices. The implementation of interest rate or commodity hedging mechanisms, besides implying a clear reduction of risk, may also be a source of strong signals to private agents that the authorities are committed to financial discipline and that they are taking the necessary steps to protect the adjustment program against future unfavorable developments. Again, the indirect positive effects might even be more important than the direct financial gains or costs derived from these operations. Expectations are thereby reinforced and secured.

Third, as noted by the staff and previous speakers, the process of regaining access to international capital markets has been limited. The re-entry process is one of the fruits of the implementation of sound economic policies, but the fruit has to mature to be eaten. This lengthy process has at least a twofold objective. Public market access, even if limited, has permitted the continuation of debt buy-back operations, thus allowing for further reductions in the stock of debt. Moreover, it has also served to set a benchmark and to give a signal to private agents in domestic and international markets on the actual level of risk premium. The voluntary access to the capital market will reaffirm expectations of financial viability and will set a precedent for domestic private agents to look for direct financing in those markets. It is worthwhile to note, as the staff does, that the voluntary return to the capital market might involve, in some aspects, not only the efforts of the debtor country but also the recognition and support of the authorities of other governments to permit these countries to issue non-investment-grade bonds in their markets. This has been, for instance, the recent experience of Mexico in tapping the Japanese "samurai" and Spanish "matador" bond markets.

Continuing with the concept of expectations, negotiations between debtor countries and their commercial banks may very well be hindered by the presence of important downside risks. In this regard, the inclusion of symmetric contingency clauses might prove to be a useful tool in removing existing uncertainties. Although we are aware of the up-front cost that these clauses might impose on the debtor country, we believe that the expected positive effects for debtors and creditors of an "external-shock-proof" debt negotiation may be higher than the actual financial costs of including these clauses. But we are also aware of the difficulties that have been found in practice, and we encourage the staff to explore this issue further.

I am very conscious that these remarks concern relatively minor issues, and I agree with Mr. Evans's excellent statement that there are other elements that may contribute significantly more to the solution to the debt problem than a "further fine-tuning of the debt strategy." In particular, further trade liberalization in the context of the Uruguay Round, as we commented extensively in the recent world economic outlook discussions (EBM/91/129 and EBM/91/130, 9/23/91; and EBM/91/131 and EBM/91/132, 9/25/91), should be an essential ingredient in any definitive solution.

The experience of some middle-income countries, where external debt restructuring has been accompanied by strong domestic policies, has shown that these countries can resume sustainable growth and regain international creditworthiness. However, the process of gradually rebuilding a stock of credibility in the financial community, as was mentioned by Mr. de Groote in the discussions on the world economic outlook, can, for some countries, be a lengthy process, even though a sustained implementation of sound economic policies is taking place and a comprehensive debt reduction negotiation is obtained.

In this regard, we believe that Fund support is crucial to bridge this transition, which may imply a deeper involvement in the future. In particular, like other speakers, we consider that it would be worthwhile to explore further the possibilities of improving the dissemination of our information and advice to creditors. Also, as is well known, our chair is of the view that there is no rationale for the present policy of segmentation of Fund resources used for commercial debt reduction operations, and these unnecessary rigidities should be eliminated.

In our recent world economic outlook discussions, I said that uncertainty, whether policy induced or resulting from debt overhang, is the fundamental constraint leading to the suboptimal allocation of private capital to developing countries, justifying the involvement of official creditors, including multilateral financial institutions. Mr. Prader has developed this argument in his statement very eloquently when discussing market failures, and I fully share his views.

Official debt relief has played a significant role; it has shown substantial flexibility in meeting debtor needs and has progressively become more concessional. However, based on current practices, and even under the assumption of strong and sustained adjustment efforts, the prospects for external viability and satisfactory growth for many low- and middle-income indebted countries are very uncertain. Further and more imaginative actions are required to provide a definitive and durable solution to the debt burden of these countries, which would be tailored to their debt-service capacity. For this purpose, a satisfactory conclusion to the ongoing Paris Club discussions on additional debt relief measures is urgently needed.

I agree with Mr. Prader that a generalization of the use of conditional or contingent financial relief, as incorporated in the recent Paris Club agreements with Poland, Egypt, and Peru, may well serve to minimize the moral hazard problem inherent in debt negotiations. A reward, in terms of official debt relief or other explicit support by official creditors and international financial institutions to highly indebted but performing developing countries, might also be an important and deserved contribution to minimizing moral hazard.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/132 (9/25/91) and EBM/91/133 (9/27/91).

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/3 through 91/6 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/91/224, Supplement 2 (9/25/91) is approved.

APPROVED: March 31, 1992

LEO VAN HOUTVEN
Secretary

Table 1

Member Country	Total Debt O/S 1989	Main Creditor Type	Fund Program Status: 12/31/83 W/ Prog	Fund Program Status: Current W/ Prog	Fund Program Status: Period No Prog	Recent Paris Clb Agreement Terms	KB Package 1989	KB Package 1990-91
I. SILICS								
Benin	1177	D		SAF		TOR		
Burundi	867	O			NP			
Comoros	176	O		SAF				
Equatorial Guinea	228	O		SAF		TOR		
Ghana	3078	O	SBA	ESAF				
Guinea	2176	O			NP	TOR		
Guinea-Bissau	458	O			NP	TOR		
Guyana	1713	O		SBA/ESAF		TOR		NEG
Kenya	5690	D	SBA	ESAF		NR		
Liberia	1761	D	SBA		ARR			
Madagascar	3607	O		ESAF		TOR		YES
Malawi	1394	O	EFF	ESAF		NR		
Mali	2157	O	SBA	SAF		TOR		
Mauritania	2010	O		ESAF		TOR		
Mozambique	4737	O		ESAF		TOR		NEG
Myanmar	4171	O			DA4/NP			
Niger	1578	O	SBA	ESAF		TOR		YES*
Nigeria	32832	O		SBA		LMIC		YES*
Sao Tome and Principe	131	O		SAF		NR		
Sierra Leone	1057	D			ARR			
Somalia	2137	O	SBA		ARR			
Sudan	12965	O	SBA		ARR			
Tanzania	4918	O		ESAF		TOR		
Togo	1185	O	SBA	ESAF		TOR		
Zaire	8843	O	SBA		ARR	TOR		
Zambia	6874	O	SBA	RAP		TOR		
Total - 26 countries	107920		11	17	9		0	3
of w/ch delayed adjustment (NP,ARR,DA4)	38.28%							

Member Country	Total Debt O/S 1989	Main Creditor Type	Fund Program Status: 12/31/83 W/ Prog	Fund Program Status: Current W/ Prog	Fund Program Status: Period No Prog	Recent PC Concsn'l Terms	KB Package: 1989	KB Package: 1990-91
II. SIMICS								
Argentina	64745	M	SBA	SBA				NEG
Bolivia	4359	O		ESAF		TOR		NEG
Brazil	111290	M	EFF		NP			NEG
Chile	18241	M	SBA			NR		YES
Congo	4316	D		SBA		LMIC		NEG
Costa Rica	4468	D		SBA		CONV	YES*	
Cote d'Ivoire	15412	D	EFF	SBA		NEG/LMIC		NEG
Ecuador	11311	D	SBA		NP			NEG
Egypt	48799	O		SBA		SPE		
Honduras	3350	O		SBA		LMIC	YES*	NEG
Hungary	20605	M	SBA	EFF		NR		
Mexico	95641	M	EFF	EFF		NR	YES*	
Morocco	20851	O	SBA		NP	LMIC		YES
Nicaragua	9205	O		SBA		NEG/TOR		
Peru	19876	M	EFF	RAP		LMIC		
Philippines	28902	D	SBA	SBA		LMIC	YES*	NEG
Poland	43324	O		EFF		SPE		NEG
Senegal	4139	D	SBA	ESAF		TOR		YES
Uruguay	3751	M	SBA	SBA		NR		YES*
Venezuela	33144	M		EFF		NR		YES*
* Total = 20 countries	565729		12	16	3		4	5
of w/ch delayed adjustment	25.36%							
excl. Brazil	5.69%							
* Overall = 46 countries	673649		23	33	12		4	8
of w/ch delayed adjustment	27.43%							
excl. Brazil	10.91%							

* Figures revised.

LEGEND:

Main Creditor Type
- O - Official Creditors
- M - Commercial Creditors
- D - Diversified Creditors

Fund Program Status
- SBA - Stand By Arrangement
- EFF - Extended Arrangement
- SAF - Structural Adjustment Facility
- ESAF - Enhanced SAF
- ARR - Arrears
- DA4 - Delayed Article IV
- NP - Needs Program, under negotiation

Financing Package
- SPE - Special more concessional terms
- TOR - Toronto Terms
- LMIC - Lower Middle Income Terms
- CONV - Conventional Terms
- NR - No rescheduling required at present
- YES* - Financing package has DDSR
- NEG - Under negotiation