

**FOR
AGENDA**

EBS/88/247

CONFIDENTIAL

December 2, 1988

To: Members of the Executive Board
From: The Acting Secretary
Subject: Review of Enhanced Surveillance

Attached for consideration by the Executive Directors is a paper on a review of the experience of enhanced surveillance, which will be brought to the agenda for discussion on a date to be announced. Conclusions and issues for discussion appear on pages 24-26.

Mr. Acquah (ext. 8661) or Mr. Leipold (ext. 8672) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

I. Introduction

This paper is submitted in response to a request by the Executive Board for a review of the experience with the implementation of the Fund's enhanced surveillance policy and procedures. It focuses mainly on countries for which such procedures have been approved by the Fund and activated (Uruguay, Venezuela, and Yugoslavia), while also touching on the experience of those countries for which the procedures were envisaged in official and/or commercial bank multiyear restructuring agreements (MYRAs) but never activated. The review covers the main issues raised by the experience to date, with an emphasis on the concerns expressed by Executive Directors on questions such as the role of the Fund in enhanced surveillance, the exercise of appropriate and effective influence on debtor countries' adjustment policies, and the duration and termination of enhanced surveillance procedures. The paper also addresses the request by Executive Directors that possible adaptations to enhanced surveillance be considered to permit access to contingency financing under the Compensatory and Contingency Financing Facility (CCFF), and examines the associated changes in the nature of the Fund's role and in procedures that would be implied.

The paper is organized as follows: Section II recalls the background to the introduction of enhanced surveillance, and sets out its main features. Section III reviews the experience with the implementation of enhanced surveillance, and examines the issues that have arisen and some lessons that may be drawn. Section IV examines the adaptations to enhanced surveillance required for the attachment of contingency financing. The main conclusions and issues for discussion are presented in the final Section V, where essentially the choices to be made regard whether or not enhanced surveillance should be retained as a possible form of Fund involvement, and whether modified enhanced surveillance for access to contingency financing should be introduced.

II. Enhanced Surveillance: Background and Criteria

In the period following the emergence of widespread debt-servicing difficulties in 1982, the Fund assumed a central role in the cooperative approach to the debt strategy. Financing packages involving restructurings of claims by both official and bank creditors normally depended upon a Fund arrangement being in place, so as to give creditors assurance that policies pursued by the debtor in question were geared toward the restoration of external viability. Such restructurings normally covered the period of a stand-by arrangement from the Fund, and typically involved one or two-year consolidation periods. By 1984-85, however, some countries that had made notable progress in their adjustment efforts were still confronted with a bunching of amortization payments that hampered their ability to resume normal access to credit markets. It was hoped that, if the bunching of repayments was

appropriately spread, these countries might be able more easily to consolidate the progress already made in adjusting their economies. To this end multiyear restructurings were developed. By providing a more realistic debt-servicing profile and a clearer planning horizon for creditors, debtors and economic agents, MYRAs were seen as facilitating a return to normal financial market relations. It was also thought that a multiyear commitment by creditors needed to be supported by a commitment from the Fund to assess and monitor the adjustment policies of the member concerned. Finally, from the Fund's own point of view, there was seen to be a need to phase out the close contacts between a member and the Fund that accompanied upper credit tranche lending and, consistent with the monetary character of the institution, to avoid an overly prolonged use of Fund resources. The Fund's enhanced surveillance policy and procedures were developed in this context.

The main guidelines on enhanced surveillance policy and procedures were laid down during a comprehensive discussion by the Executive Board in September 1985, when Executive Directors considered the role of the Fund in assisting members with commercial banks and official creditors. 1/ The discussion took place against the background of concern about enhanced surveillance provisions contained in bank loan covenants, and served to circumscribe the cases to which such procedures could apply. The principal objective was to establish a framework of orderly procedures that would, under certain circumstances, respond to the need to help members with a sufficiently strong record of adjustment to make progress in addressing their debt problems and improving their relations with creditors, with the ultimate view of regaining spontaneous access to capital markets.

The operational modalities adopted for enhanced surveillance were centered around three separate elements: (i) a quantified financial program, prepared by the country authorities, presenting a comprehensive description of major macroeconomic objectives and the supporting policies; (ii) annual consultations to review and assess the authorities' quantified program, together with interim consultations aimed at assessing progress in the implementation of the program, and discussions of the related staff reports by the Executive Board; and (iii) the release of staff reports by the member country to creditors party to the MYRA in support of which the Fund approved enhanced surveillance. 2/ Under these procedures, the Fund would be involved at the request of the member in advising in the design of the economic program and in monitoring developments, without an upper credit tranche arrangement being in

1/ At EBM/85/132, 9/4/85 based on "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors" (EBS/85/173, 7/23/85; and Supplement 1, 8/13/85).

2/ The procedures for transmittal of staff reports under enhanced surveillance were laid down by the Executive Board in Decision No. 8222 - (86/45), March 12, 1986--Selected Decisions of the International Monetary Fund, Thirteenth Issue, page 19.

place. This would involve a closer cooperation than would be the case under the Fund's surveillance conducted under regular Article IV consultations, but less close than that involved during the period of a stand-by or EFF arrangement, and would not involve Fund approval of the program submitted by the member. Information on the program and its implementation, as well as the staff's assessment of the situation, as contained in the staff reports, would be made available by the authorities to creditors on a timely basis. In addition to the staff report, official creditors would also receive the Chairman's summing up of the Executive Board discussion. Creditors would then need to weigh that information, together with any available from other sources, to arrive at their own judgment about the economic performance of the country and to make their financing decisions.

At the time of their September 1985 discussion, Directors observed that the practice of enhanced surveillance involved some risks. ^{1/} In particular, they stressed the possible weakening of Fund conditionality, and feared that the Fund might tend to become too deeply and too specifically involved with the commercial banks, creating a generalized reliance on the Fund's judgment by the international community that could affect the institution's credibility and interfere with the normal functioning of financial markets. To avoid this outcome, Directors stressed that it was important that the Fund should not provide on/off signals to the market and that, to be consistent with the aim of normalizing market relations, the responsibility for lending decisions should be left to creditors. Furthermore, enhanced surveillance was not to become a substitute for stand-by and extended arrangements, or in any way to dilute the Fund's normal procedures.

In light of the above considerations, enhanced surveillance was conceived as an exceptional and temporary adaptation of the Fund's policies and procedures designed to be used on a limited and selective basis, essentially to help promote MYRAs for the benefit of member countries which had achieved significant domestic and external adjustment, and to ease the transition to voluntary market borrowing and spontaneous capital flows. Four main criteria were considered relevant for the Fund when deciding to provide enhanced surveillance for a member. First, there should already be a strong record of adjustment to provide assurance that adequate policies were likely to be maintained and to underpin the expectation of a normalization of relations with creditors within a reasonable time frame. Second, sufficient progress in adjustment must already have been achieved to limit the member's needs for net external financing (beyond the initial relief provided by the MYRA) to amounts that could, with confidence, be expected to be forthcoming spontaneously. Third, the member must be able to present a fully articulated and quantified policy program, the formulation and

^{1/} The Chairman's summing up of the Board discussion appears in Selected Decisions of the International Monetary Fund, Thirteenth Issue, pp. 20-23 (see Attachment I).

assessment of which would provide a basis to strengthen both the member's economic and financial programming and creditors' risk assessment procedures. The fourth, and more general criterion, was that enhanced surveillance should benefit the member and promote the normalization of market relations, with a view to limiting the Fund's agreement to enhanced surveillance only to cases where the Fund judged the procedures to be essential.

Enhanced surveillance procedures have been approved by the Executive Board and implemented for three member countries. Enhanced surveillance procedures for Venezuela for the period from 1985 to 1997 were the first to be approved by the Board, in May 1985. They were not however fully implemented immediately since the authorities did not release staff reports to creditors until mid-1986, due to delays in the signing of the commercial bank MYRA. Enhanced surveillance for Yugoslavia was approved in March 1986 for the period from May 1986 through calendar year 1991; the procedures were suspended in June 1988 with the approval of a one-year stand-by arrangement. ^{1/} Finally, enhanced surveillance for Uruguay was approved in July 1987 for the period through 1989.

Interest was expressed in enhanced surveillance procedures for four other members in the context of MYRAs concluded in 1985-86, but these were never implemented. ^{2/} Mexico, whose specific circumstances influenced the concept and practical modalities of enhanced surveillance, was due to be covered by enhanced surveillance procedures from January 1986, following the expiry of an extended arrangement from the Fund. The procedures were to extend through 1990 or 1994, depending upon the date of the final repayment of the 1983 new money package. The authorities presented a quantified financial program to Mexico's bank creditors, but the program was never reviewed by the Fund staff under the enhanced surveillance procedures. The sharp drop in oil prices in late 1985 led to a deterioration in Mexico's balance of payments prospects, and the authorities instead requested a stand-by arrangement from the Fund, which was approved by the Board in November 1986. The official and bank MYRAs concluded in 1985 for Ecuador envisaged a continuation of stand-by arrangements through 1986 (commercial bank creditors) or March 1987 (official creditors), followed either by further Fund arrangements or enhanced surveillance. In the event, enhanced surveillance procedures never came into effect, as lower world market prices for oil and the damage caused by an earthquake in early 1987 led to the cancellation of the then existing stand-by arrangement from the Fund on June 10, 1987; a new arrangement for a 14-month period

^{1/} Although the term "enhanced surveillance" will be used throughout this paper, it should be noted that in the case of Yugoslavia the term "enhanced monitoring" is frequently used.

^{2/} For countries that concluded MYRAs in 1987-88, the issue of the implementation of enhanced surveillance has not yet arisen as Fund arrangements are still in place or being discussed.

was approved on January 4, 1988 but has since become inoperative as the mid-term review could not be completed. A new comprehensive rescheduling with official creditors and an agreement in principle with commercial banks were also concluded, neither envisaging enhanced surveillance. The agreement with banks has not been signed. Similarly, the enhanced surveillance procedures (or analogous arrangements) foreseen in the bank and/or official MYRAs concluded in 1986 with the Côte d'Ivoire and the Dominican Republic were not implemented, as adverse developments led to the need for further Fund financial support and new rescheduling agreements in the case of the Côte d'Ivoire, and to a suspension of the annual consolidations under the bank MYRA in the case of the Dominican Republic.

III. Issues in the Implementation of Enhanced Surveillance

Since 1986, a number of Board papers 1/ have reviewed in some detail the specific country experiences in the implementation of enhanced surveillance. The tables in Appendix I set out an updated chronology of events related to enhanced surveillance for Venezuela, Yugoslavia, and Uruguay. This section draws on the experience of implementation of enhanced surveillance in these three member countries, and reviews the main issues which have arisen regarding the role of the Fund, the exercise of effective and appropriate influence on the policies of the debtor countries concerned, and the duration and termination of enhanced surveillance procedures. The main conclusions are summarized in a final sub-section.

A first general review of enhanced surveillance was conducted by the Executive Board in March 1987, 2/ when experience with its implementation was limited to two countries (Venezuela and Yugoslavia). On that occasion, Executive Directors endorsed continuation of the procedure in appropriate cases. Several Directors noted that it was disappointing that in the early experience with enhanced surveillance substantive differences remained between the Fund's and the authorities' views on the appropriateness of or the desirable speed of implementation of adjustment policies. Most Directors, nevertheless, considered that the enhanced surveillance procedure, as initially adopted, remained

1/ See "International Capital Markets: Developments and Prospects, 1986" (SM/86/193, 8/5/86); "International Capital Markets - Recent Developments, 1986" (SM/86/201, 8/14/86); "Recent Experience with Multilateral Official Debt Restructuring" (SM/86/194, 8/7/86); "Implementation of the Debt Strategy - Current Issues" (EBS/87/38, 2/20/87); and "Recent Developments in Multiyear Restructuring Agreements and Enhanced Surveillance" (SM/88/66, 3/18/88).

2/ At EBM/87/50, 3/8/87 based on "Implementation of the Debt Strategy - Current Issues" (EBS/87/38, 2/20/87). The Chairman's summing up of the Board discussion was circulated as SUR/87/32, 3/23/87.

appropriate. It was stressed that in approving enhanced surveillance close attention needed to be paid, if the procedure was to be effective, both to the criterion that the member had a strong record of adjustment and to the continued willingness of creditors to exercise appropriate influence. Certain Directors indicated that arrangements for enhanced surveillance should be limited in their duration and should not continue in the event of inadequate cooperation by the member.

1. Role of the Fund

The role of the Fund in enhanced surveillance may be distinguished according to three chronological stages: the introduction, the approval, and the implementation of the procedures. First, the introduction of the concept of enhanced surveillance and its adoption as part of the Fund's procedures, albeit on an exceptional basis, was intended to provide the necessary degree of confidence for creditors to agree to multiyear reschedulings, seen as a necessary step in the normalization of debtor-creditor relations at a difficult juncture in the debt strategy, and as a step toward a less close relationship between the member and the Fund than that implied by an arrangement involving the use of Fund resources. Second, the approval of enhanced surveillance procedures for individual member countries was to be guided by agreed criteria aimed at providing some assurance as to the continuation of adequate policies. Third, in the case of activation and implementation of enhanced surveillance, the provision by the Fund of timely, candid and comprehensive assessments of the member's policies was intended to support creditors' risk evaluation, providing an input for their lending decisions, and assist the member in considering whether or not its policies needed adaptation. These three aspects are reviewed below on the basis of the experience to date.

a. The promotion of multiyear rescheduling agreements

In all of the early MYRAs, signed during 1985-86, 1/ bank creditors sought to ensure enhanced surveillance of the country's policies for a given period after the expiration of existing or envisaged Fund arrangements. Similar provisions governed the MYRAs with official creditors concluded in those years. 2/ There was thus a clear interest on the part of creditors in ensuring linkage to enhanced surveillance procedures during their multiyear reschedulings. Creditors' agreement to these rescheduling and concerted financing packages would almost certainly have been more difficult to secure in the absence of this form of Fund involvement. The introduction of enhanced surveillance procedures thus helped foster the cooperative approach to the debt strategy, with the Fund providing (or standing ready to provide, under

1/ On the basis of the date of signature: Mexico, Ecuador, and Yugoslavia in 1985; Côte d'Ivoire, the Dominican Republic, Uruguay, and Venezuela in 1986.

2/ Ecuador (1985); Côte d'Ivoire and Yugoslavia (1986).

certain circumstances) a specific service, at the member's request, to help the member normalize its relationship with creditors and prospectively regain access to international markets on nonconcerted terms.

A central aim of the procedures--to facilitate bank or official MYRAs--was thus secured. The ultimate objective of facilitating a return to spontaneous financing proved however to be more elusive than anticipated. As noted above, enhanced surveillance procedures were actually activated for only three member countries (and since then suspended in one case) as several countries for which the procedure had been envisaged in their debt restructuring agreements never requested it from the Fund. Thus, while interest in enhanced surveillance has not been lacking, adverse external developments and slower than envisaged progress by countries in adjusting their economies have effectively restricted demand for it and meant that it has remained an exceptional procedure.

MYRAs have eased the debt-servicing problems of the countries concerned, but there has been limited progress toward external viability and a return to normal market access for those developing countries that experienced little or no access since the onset of widespread debt-servicing problems in 1982. Of the countries that have rescheduled their debt in the 1980s, Turkey is a clear example of a member that has been able to regain more than modest spontaneous medium-term access to the international financial markets; for others, however, this prospect has been more elusive. Venezuela returned to the international bond market in February 1988, with a US\$100 million fixed-rate issue yielding 3½ percentage points above the U.S. Treasury note rate. The depth and duration of the debt crisis has led to lingering doubts among private creditors as to whether creditworthiness will be restored in a reasonable time frame. This has been manifest not only in commercial banks' reluctance to increase their exposure, but also in their stepped-up loan loss provisions, in the restructuring of their portfolios, and in many instances in the decision to withdraw from such lending.

In this context, there has been lesser emphasis on enhanced surveillance procedures in recent bank covenants. While traditional linkages to Fund arrangements have remained, there has also been increasing recourse to other types of assurances, such as World Bank disbursements and links to the scale of contributions from official creditors, with clauses concerning minimum amounts of debt relief from Paris Club or financing from bilateral sources. Of the 15 MYRAs signed or agreed in principle in 1987 and so far in 1988 (excluding mere modifications of previous MYRAs), 1/ only 5 seek to ensure enhanced

1/ Argentina, Chile, Honduras, Jamaica, Mozambique, Philippines, and South Africa in 1987; Brazil, Côte d'Ivoire, Malawi, Nigeria, Poland, Togo, Trinidad and Tobago, and Yugoslavia in 1988.

surveillance of the country's policies for a given period of the agreement. 1/ Additionally, with regard to official creditors, there were no new MYRAs or serial rescheduling agreements after the first half of 1986. 2/ With the continuing obstacles to a resumption of spontaneous capital flows, the number of countries that could use enhanced surveillance procedures appears to be further circumscribed by the consideration that such procedures are intended to apply to countries whose net external financing needs can confidently be expected to be forthcoming spontaneously. Finally, the original need to facilitate the conclusion of MYRAs through the provision of assurances regarding the monitoring of policies in debtor countries (via enhanced surveillance procedures) appears to have become less important, given that the obstacles to the conclusion of agreements are now more often due to the lesser degree of bank cohesion, an issue which has to be resolved primarily within the banking community itself. 3/

b. Criteria for the approval of enhanced surveillance

A second aspect of the role of the Fund in enhanced surveillance relates to the approval of enhanced surveillance procedures for a given member, and to the criteria governing such approval as set out in Section II above. The experience to date with enhanced surveillance would indicate that in applying the criterion that the member should have "a strong record of adjustment," the benefit of the doubt appears to have been extended to the member in some cases at the time of approval of the procedures. 4/ Under this criterion, enhanced surveillance was to have been limited to cases where there was firm evidence that the country had undertaken a successful adjustment effort,

1/ Argentina, Brazil, Chile, Philippines, and Yugoslavia. The lesser frequency of enhanced surveillance provisions in the recent MYRAs is highlighted in Table 1; details of the provisions concerning enhanced surveillance in commercial bank MYRAs are contained in Table 2.

2/ The recent agreement with Brazil (August 1988), though covering an extended consolidation period, is not serial in nature. As noted in "Official Multilateral Debt Rescheduling: Recent Experience" (SM/88/45, 2/19/88), official creditors have nevertheless continued to provide long effective consolidation periods to countries seeking successive rescheduling agreements.

3/ Weakening bank cohesion has in part been addressed by further development of the menu approach and by legal adaptations that lift out recalcitrant banks.

4/ The staff report (EBS/86/38, 2/19/86) discussed at the Board meeting which approved enhanced surveillance procedures for Yugoslavia noted "uncertainties regarding the steadfastness of the adjustment policies," and considered as a matter of concern "the tendency to delay or temporarily suspend implementation of the key policies." The Chairman's summing up (SUR/86/21, 3/14/86) also stressed "the need for constancy of policy and for improved cohesiveness of financial policies."

Table 1. Commercial Bank MYRAs, 1985-88

Year <u>1/</u>	With ES Provisions <u>2/</u>	Without ES Provisions
1985	Ecuador Mexico Yugoslavia	--
1986	Côte d'Ivoire Dominican Republic Uruguay Venezuela	--
1987	Argentina <u>3/</u> Chile Philippines Venezuela <u>4/</u>	Ecuador <u>4/</u> <u>5/</u> Honduras <u>5/</u> Jamaica Mozambique <u>3/</u> South Africa
1988	Brazil Chile <u>4/</u> Uruguay <u>4/</u> Yugoslavia <u>3/</u>	Côte d'Ivoire <u>5/</u> Malawi <u>3/</u> Nigeria <u>3/</u> Poland Togo <u>3/</u> <u>5/</u> Trinidad and Tobago <u>5/</u>

Source: Restructuring agreements.

1/ Agreement either signed or reached in principle (if signature not yet taken place).

2/ Understood as either specific reference to enhanced surveillance procedures or language intended to make such reference (e.g., Fund "monitoring procedures") for periods during which a financial arrangement from the Fund is not in place.

3/ MYRAs that, unlike previous exercises, entail a restructuring of all eligible debt outstanding as of a certain date.

4/ Modification of earlier agreement.

5/ Agreed in principle or tentative agreement with banks' Steering Committees. The 1987 agreements in principle with Ecuador and Honduras are now considered inoperative, as is the 1988 agreement with Côte d'Ivoire.

exercise appropriate influence" (SUR/87/32, 3/23/87). Since the Fund is not called on to endorse the member's policies as consistent with the criteria for the use of Fund resources, 1/ its role is exercised primarily through persuasion, in a manner similar to that exercised in the implementation of Article IV surveillance procedures. The weight of the Fund's assessment will vary over time and circumstances, depending primarily on the degree of the member's commitment to adjustment policies, but also on the signals creditors may decide to provide on the basis, inter alia, of that assessment to encourage the timely adoption of corrective measures.

The influence that creditors can exercise depends inter alia on whether a rescheduling is block or serial in nature, on the monitoring arrangements and triggers (if any) agreed upon, and on the type and extent of default clauses. It clearly also will depend on the focus of interest of creditors and on the different weights which they may give to concerns in various areas of policy. A "serial" rescheduling provides creditors as a group with a potentially active role, as the restructuring of maturities falling due in later years is made dependent on the satisfaction of certain conditions or, at least, made subject to specific creditor approval. 2/ This practice places particular responsibility on creditors to determine the adequacy of policies. If, in their judgment, based inter alia on the Fund staff appraisal, the member country needs to adapt its policies, creditors may decide to take certain steps well defined in the restructuring agreement. Similarly, creditors have sought to exercise influence by including in certain agreements "triggers" as early warning signals of possible difficulties and of the possible need for consultations between the member and its creditors on the desirability of remedial actions. Finally, events of default constitute the ultimate sanction if developments are viewed as being of severe concern to creditors; because of their far-reaching effects they have, however, never been invoked under the MYRAs in force to date. 3/

The rescheduling agreements concluded with the three countries for which enhanced surveillance procedures have been approved include different clauses allowing for the exercise of creditor influence. The greatest scope for such exercise, at least potentially, was provided by the agreement with Yugoslavia. Both the bank and official MYRAs (signed

1/ Incidentally, such endorsement would have to be obtained if enhanced surveillance were modified to permit access to contingency financing (see Section IV below).

2/ As, for example, in goodwill clauses in the Agreed Minute of Paris Club reschedulings, which refer to creditors' willingness to meet to consider further debt relief in the future, subject to fulfillment by the debtor country of certain specified conditions.

3/ Events of default refer to any event which allows creditor banks to declare the outstanding principal as well as all accrued interest payable on demand.

respectively in December 1985 and in May 1986) were serial in nature, requiring decisions by creditors during the first half of 1987 for the second stage of the respective rescheduling arrangements to become effective. In the case of the bank agreement, the second part of the consolidation covering 1987-88 was conditional inter alia on a finding by creditors that Yugoslavia's economic and financial policies were consistent with a continuing ability to service its external debt. In addition, a novel aspect of the bank MYRA with Yugoslavia was the inclusion of trigger clauses (applying to external reserves and export earnings) to indicate likely difficulties in meeting future repayments. Similarly, the MYRA with Paris Club creditors envisaged a two-stage debt relief, with the second stage (May 1987-March 1988) subject inter alia to a "positive assessment" by participating creditor countries of the authorities' program set forth in the context of enhanced surveillance. Official creditors also indicated that "in the case of a negative assessment" in the Fund staff reports, the possibility would be open to creditor countries to request that "the Yugoslav authorities request an acceleration of the consultation schedule with the Fund in order to ascertain the extent and content of remedial action necessary." ^{1/} In the event, these clauses were not invoked by creditors, and the second stage of the debt relief was implemented by both bank and official creditors in May-June 1987, despite the overall critical tenor of the two staff reports under enhanced surveillance already released at that time (see Chronology in Appendix). Creditor signals to the authorities that the policies followed were not conducive to a return to normal market access were provided in other forms: for instance, the discussions with official creditors were protracted and difficult, underscoring creditors' concerns, and commercial bank claims on Yugoslavia declined by US\$1.8 billion in 1986-87. ^{2/}

At the outset of enhanced surveillance for Yugoslavia (EBM/86/45, 3/12/86), several Directors commented that the authorities' first policy program under enhanced surveillance, although apparently satisfactory to commercial bank creditors, might not have been adequate for official creditors to agree to a rescheduling. In the event, the program was not strengthened, and the Agreed Minute with Paris Club creditors was initialed in April and signed in May 1986. Following the release of the first Article IV consultation report under enhanced surveillance (SM/86/176, 7/17/86) in August 1986, which expressed concern about the course of economic developments, both the commercial banks and official creditors had direct contacts with the Yugoslav authorities. In September 1986, official creditors considered the staff report (together with the Chairman's Summing Up - SUR/86/83, 8/14/86), and sent a letter

^{1/} Memorandum of Understanding on Enhanced Monitoring; see "Yugoslavia - Report on Renegotiation of the External Debt" (EBS/86/96, 4/25/86, Annex A-I).

^{2/} According to IMF-based data on cross-border lending by banks derived from the Fund's international banking statistics (IBS), excluding changes attributed to exchange rate movements.

to the Yugoslav authorities noting their deep concern about recent policy measures and the need for quick corrective action. The letter also noted that the full implementation of the economic program outlined earlier by the authorities was essential for the second stage of the consolidation. The option of requesting an advancement of the consultation schedule 1/ was not exercised. Commercial banks, for their part, appear to have held at that time a rather more favorable view of developments than was reflected in the staff's assessment, possibly as a result of their greater emphasis on the immediate external outturn that had been relatively favorable.

The second staff report under enhanced surveillance for Yugoslavia (SM/87/53, 2/20/87), which again contained an unfavorable appraisal, was released to creditors in March 1987, at the time when they were to decide on the implementation of the second stage of the consolidation. Official creditors requested a further Fund assessment of the policy statement presented by the Yugoslav authorities at the Paris Club meeting of March 30, 1987. The assessment (SUR/87/38, 4/21/87) reiterated the need for a further strengthening of policies; in May-June 1987 both commercial bank and official creditors completed the second stage of the consolidation. In August 1987, the third staff report under enhanced surveillance (SM/87/187, 7/30/87 and Supplement 1, 8/27/87) was released; the staff considered that an integrated package of adjustment measures was imperative and should be supported by a timely approach to creditors.

A further significant deterioration in the economic situation in the fall of 1988 induced the authorities to request that new debt rescheduling negotiations be opened. In October-November 1987, official and commercial bank creditors, on the basis, inter alia, of the above staff report, signaled to the Yugoslav authorities that any further rescheduling would be contingent on an upper credit tranche arrangement from the Fund. A one year stand-by arrangement was approved in principle on June 1, 1988, and went into effect on June 28, 1988, and enhanced surveillance procedures were suspended for the period of the arrangement. The new agreement with commercial banks commits the Yugoslav authorities to request enhanced surveillance for the period between 1989 and 1993 (compared to 1991 in the previous agreement) that is not covered by an arrangement with the Fund.

The bank agreements with Venezuela (both the original agreement signed in February 1986 and its modification which became effective in November 1987) restructured a complete block of maturities, and thus did not include a specific provision for a date on which banks could decide

1/ Which could have been considered necessary to "ascertain the extent and content of remedial action" and to "seek to ensure that an assessment of such action is on hand in time for the decision date for the next consolidation period"--Memorandum of Understanding on Enhanced Monitoring, EBS/86/96, 4/25/86, Annex A-I.

to discontinue the restructuring, although two thirds of the banks could at any time call an event of default if they considered Venezuela's economic program unsustainable. Also, a decrease in operating reserves of the Central Bank below US\$2 billion would trigger an event of default. At end-1986, negotiations were reopened between Venezuela and commercial banks to modify the previous MYRA in view of the sharp decline in world oil prices (see Chronology in Appendix). At the time, bank creditors had been provided with the staff report for the 1986 Article IV consultation (SM/86/152, 6/25/86). ^{1/} The report indicated substantial differences of view between the authorities and the staff, and urged the authorities to adopt promptly a comprehensive program designed to adjust the economy to the decline in oil export revenues. In the event, although there was a significant adjustment of the controlled exchange rate in December 1986, the needed comprehensive redirection of policies was not implemented. Creditors received a further staff report in early 1987 (SM/87/22, 1/21/87), which again called for a move to a unified and flexible exchange rate and the adoption of tighter demand management policies. A preliminary agreement on a modified MYRA was reached with the commercial banks' advisory committee in February 1987 and became effective in November 1987. It appears that, in the related negotiations, commercial banks gave greater weight to different concerns than those expressed by the staff. The principal focus of commercial creditors' concerns was on the regulations governing private sector external debt servicing (including debtors' access to foreign exchange at preferential rates) following completion of the process of registration of private external debt. Since late 1986 Venezuela has repaid US\$2.1 billion to banks under the MYRA. In the same period, lines of short-term credit were open and four-month trade credits rose by about US\$4 billion. The two most recent staff reports (SM/87/243, 10/19/87 and SM/88/165, 8/3/88) both recommended a significant tightening of policies; the latter report calls for a strengthening of financial policies without delay; it supports the authorities' aim of improving voluntary access to foreign financial markets, but notes that the ability to raise new funds abroad will depend importantly on the economic policies pursued.

Executive Directors generally agreed with the thrust of the staff's assessment and expressed the view that "present policies could not be sustained for long" and that, on this basis, "medium-term prospects were not altogether encouraging." Several Directors expressed the hope that "the authorities would give greater weight to the views of the Fund in choosing the policy adaptations under consideration, thereby increasing the credibility of their economic strategy vis-à-vis foreign lenders" (SUR/88/93, 10/26/88). On October 20, 1988, the Venezuelan authorities took a number of measures toward a reform of the exchange system (described in EBD/88/326, 11/14/88), constituting a significant step

^{1/} The earlier two reports issued under enhanced surveillance (SM/85/115, 4/24/85 and SM/85/308, 11/15/85) were not released by the Venezuelan authorities to creditors as the MYRA had not yet been signed.

toward the objective of unification, although the system continues to be affected by dual exchange rates and a multiplicity of subsidies. The further weakening of world oil prices has widened the prospective external gap for 1988, and the authorities have been engaged in the process of attempting to raise financing to cover this gap, including recourse to short-term borrowing, bond issues and loans backed by future oil export receipts.

Finally, the bank MYRA with Uruguay signed in July 1986 was on a serial basis, with five successive annual reschedulings in each of the years covered by the MYRA being subject to the condition precedent that Uruguay have in place either a stand-by arrangement from the Fund or enhanced Article IV surveillance. This represents a simple linkage, with no specific reference to "positive assessments" on the part of creditors. A two thirds majority of the banks could declare an event of default if, in their reasonable judgment, based on the Fund reports under enhanced surveillance, "the implementation of the economic program for any year is or would be incompatible with a viable external payments position consistent with continuing debt service or that there has been a deterioration in the financial or economic condition of Uruguay." A new agreement with commercial bank creditors was signed in March 1988, which converted the MYRA from a serial to a block arrangement, extending at the outset the amortization schedule of both past and future maturities and thereby eliminating the above-mentioned condition precedent. Under the modified agreement, Uruguay is to have in place either a Fund stand-by arrangement or enhanced surveillance procedures for the same period as in the earlier agreement; the above-mentioned event of default also applies. Staff appraisals contained in the two staff reports issued under enhanced surveillance for Uruguay to date have been broadly positive.

The strength of a member's commitment to adjustment policies is a crucial component of effective enhanced surveillance. The above review indicates that, in the absence of a firm commitment, the signals sent by creditors and their decisions taken in the light, inter alia, of the staff assessments provided under enhanced surveillance have, in practice, generally not been successful in persuading the authorities to adopt corrective policies of a sufficient strength and in as timely a manner as, hindsight suggests, would have been desirable. In these circumstances, divergences have persisted in some cases between the policies of the authorities and those recommended by the staff and the Executive Board. Apart from possible differences in assessments and priorities as between the Fund and the commercial creditors, there may also have been a tendency to view enhanced surveillance as an umbrella provided by the Fund which allowed a certain complacency about a country's situation.

3. Duration and termination of enhanced surveillance

The first cases for which enhanced surveillance procedures were approved envisaged a prolonged duration of Fund involvement: from May 1985 through 1997 (corresponding to the final maturity of the

rescheduled debt under the original MYRA) in the case of Venezuela, and from May 1986 through 1991 (corresponding to the consolidation period plus a grace period of three years under the bank MYRA) in the case of Yugoslavia. In their September 1985 discussion, ^{1/} Executive Directors judged such periods to be excessively prolonged and the summing up (Buff 85/152, 9/6/85) recommended limiting enhanced surveillance as much as possible to the consolidation period, while remaining open to the possibility of an extension a little beyond this period where considered appropriate. In accordance with this position, enhanced surveillance for Uruguay was approved in July 1987 for the period through 1989, corresponding to the end of the consolidation period under the 1986 MYRA with commercial banks.

The question of the termination of enhanced surveillance for a member for which it has been approved has been raised on a number of occasions, and was examined in some detail in the paper providing the basis for the first general review of enhanced surveillance procedures in March 1987. ^{2/} No firm conclusions were reached, however, and the issue arose again (at EBM/88/88, 6/1/88) on the occasion of the suspension of enhanced surveillance for Yugoslavia for the period of the current stand-by arrangement (i.e., through June 1989). Although close observance of the recommendation to limit enhanced surveillance procedures to relatively shorter periods should lessen the incidence or the need for an early termination of such procedures, there nevertheless remains a need for general guidelines on the issue.

There are a number of circumstances in which enhanced surveillance could be terminated before its normal expiration date. First, it is clear that a member may at any time withdraw its request for enhanced surveillance. The Fund would obviously abide by this decision of the member, whether or not it had been taken in agreement with the country's creditors. Second, while it seems logical that enhanced surveillance should at least be suspended in the case of a Fund arrangement in the upper credit tranches, there are arguments which would favor its outright termination in such circumstances, with the possible approval of new procedures being examined on its own merits at the time of the arrangement's expiry, if the member so requested. This position was taken by a number of Executive Directors at the time of the approval of the stand-by arrangement for Yugoslavia. In general, it does not appear appropriate for the Fund to precommit itself to a particular type of involvement in the future, in the absence of knowledge as to the presence or otherwise of the required criteria and circumstances for such involvement. It would, for example, be clearly inappropriate for

^{1/} Although at the time enhanced surveillance for Yugoslavia had not yet been formally approved, the Executive Board had been informed on April 29, 1985 of the Yugoslav authorities' intentions in this respect and of the possible duration of the procedures.

^{2/} "Implementation of the Debt Strategy - Current Issues" (EBS/87/38, 2/20/87, pp. 38-40).

enhanced surveillance procedures to be resumed automatically in the case of a stand-by arrangement which became inoperative because of policy slippages.

It also bears noting that both the suspension or termination of enhanced surveillance in the case of a Fund arrangement in the upper credit tranches should imply a cessation of the authorization to release staff reports to creditors. It is the policy of the Fund that members should not release staff reports other than in the context of enhanced surveillance, notwithstanding any bank covenants that may provide otherwise. At all events, the provision of clear signals to creditors on the appropriateness and effective implementation of policies inherent in the approval and continued drawings under a Fund arrangement eliminates the rationale for the exceptional agreement by the Fund to allow members to make staff reports available to creditors.

A third circumstance in which the termination of enhanced surveillance would appear appropriate arises when a MYRA, in support of which enhanced surveillance had been approved, was itself terminated, as the basis for the procedures would no longer be present.

A fourth case of termination could arise, as some Executive Directors have suggested, "in the event of inadequate cooperation by the member" (SUR/87/32, 3/23/87). Where such inadequacy were to consist in a less than full cooperation on the part of the member in the provision of information and participation in the discussions necessary for the preparation of the staff assessment of its policies, there would seem to be ground for the Fund to terminate the procedure unilaterally. Whether "inadequate cooperation" should also cover cases where there were persistent divergences of views with the member country is a matter for Executive Directors to consider. Previous examinations of this issue have tended to take the view that termination in such circumstances may not be appropriate, as the Fund's initial approval of enhanced surveillance was not conditional on the continued implementation of policies favored by the Fund nor does the Fund necessarily consider the member's program to be adequate. Furthermore, terminating enhanced surveillance because of a failure by the member to maintain adequate policies would provide creditors with a clear on/off signal, whereas the basic tenet of enhanced surveillance was to move away from such signals. Notwithstanding these arguments, there would also appear to be a case, on the basis of experience to date, for adaptations of enhanced surveillance which could strengthen the Fund's influence over members' policies. In particular, it could be argued that the strong record of adjustment criterion should be applied on a continuing basis, and not merely at the time of the approval of the procedures, and that a weakening of the adjustment effort, leading to serious divergences of views on policies, could constitute grounds for a unilateral termination of the procedures on the part of the Fund.

4. Conclusions on the experience with enhanced surveillance

The experience to date with enhanced surveillance procedures allows some general conclusions and implications to be drawn for the future. A general caveat must, however, apply to such conclusions. The experience with enhanced surveillance has been limited to only three member countries, and in an external environment which did not facilitate the transition to normal market access. This qualification is important and serves to put into proper perspective some of the initial difficulties with the procedures.

First, the introduction of the procedures as a possible form of Fund involvement was instrumental in facilitating the conclusion of all of the early MYRAs (1985-86), thus securing one of its important objectives in helping to foster a cooperative approach to the debt strategy and overcome a potentially difficult phase. The ultimate objective of restoring external viability and normal market access for the countries concerned has, however, proved to be more elusive than initially hoped. Also, enhanced surveillance provisions have become less widespread in more recent MYRAs, indicating a lesser emphasis on this form of Fund involvement.

Second, the approval of enhanced surveillance procedures for individual countries would appear, in some cases, to have extended the benefit of the doubt with respect to the criterion that the member have a strong record of adjustment. This judgmental element will remain critical in evaluating future requests for enhanced surveillance. Therefore, it is important that, at the time of a request by a member country, the staff provide a clear, comprehensive and frank assessment to allow Executive Directors to judge the prospects for success under the procedures.

Third, the Fund's role in the implementation of enhanced surveillance through the provision of comprehensive and candid assessments of a member's policies appears to have been adequately fulfilled. The process has however not always succeeded in promoting the timely adoption of sufficiently strong corrective policies in the light of negative staff assessments. This aspect in the experience to date would appear to counsel additional caution when examining future requests for enhanced surveillance. Attention will have to be paid to the scope afforded for the exercise of appropriate influence by the provisions of the multiyear agreements, and to the presence or otherwise of an agreement with official creditors, although neither of these elements provide sufficient assurances per se. In this connection attention should also be paid to the possible frictions that may arise under a procedure in which the Fund agrees to make candid assessments of the economic policies of one of its members for the benefit of both the member and its creditors, and where one or both parties then seem largely to disregard the Fund's views. The only way for the Fund to play a stronger role in influencing the adoption and implementation of appropriate policies would be to require a negotiated program and an endorsement of

the member's policies by the Fund, thereby importantly altering the concept of enhanced surveillance as developed to date. In past discussions, 1/ most Executive Directors have stressed that the Fund's seal of approval should not be separated from the use of the Fund's resources, including the approval of Fund arrangements of a precautionary nature.

Fourth, with regard to the duration of enhanced surveillance, any future approvals should adhere to the principle of limiting the procedures as much as possible to the consolidation period, with the possibility of an extension a little beyond this period if considered appropriate.

Fifth, the experience to date has raised two particular issues with regard to the termination of enhanced surveillance procedures. The first relates to cases in which the member uses Fund resources in the upper credit tranches. A termination--rather than a mere suspension--of the procedures in such cases would ensure that the Fund maintains the necessary autonomy in determining the nature of its involvement upon the expiry, cancellation, or inoperational status of the Fund arrangement. A second possibility regards termination in the cases of "inadequate cooperation" by the member. The need to strengthen influence over members' policies and the advisability of observing the criterion of a strong record of adjustment on a continuing basis would argue in favor of the possibility of a unilateral termination of the procedures on the part of the Fund in the case of prolonged or serious divergences of view on the adequacy of policy. This would however provide a definite "off" signal to the market, and caution would need to be exercised. A shortening of the duration of enhanced surveillance should lessen the probability of needing to consider an early termination. All cases of termination or suspension of enhanced surveillance should imply a cessation of the authorization to release staff reports.

The above considerations are based on the assumption that enhanced surveillance procedures are retained as a form of Fund involvement, albeit on an exceptional and case-by-case basis, and attempt to identify those changes which seem to be required by the experience to date. This course of action would allow the Fund to continue to provide a service which has been considered useful by a number of members and would also cause the least perturbation in the evolving relationship between the Fund, indebted member countries, and official and commercial bank creditors.

Circumstances have, however, changed since the procedures were first introduced, with the Fund's role in facilitating MYRAs as such--other than through its traditional function of helping countries determine and implement appropriate policies within a balanced mix of

1/ Notably in relation to the monitoring arrangements for Colombia approved in mid-1985, whose extension to other countries was considered "unlikely and undesirable" by the majority of Executive Directors (at EBM/85/132, 9/4/85).

adjustment and financing--being less important than when multiyear agreements were a relative novelty. Furthermore, the uncertainties as to the response of the debtor country to the representations made to it by creditors about the need for policy adjustment has raised questions as to the effectiveness of enhanced surveillance.

These considerations raise the issue of whether, in the present changed circumstances, there is still a need to retain enhanced surveillance procedures as a possible form of Fund involvement. While the arrangements that have already been approved would need to be grandfathered, and those already contained in bank covenants examined when and if the members concerned request their implementation, the Fund could conceivably signal to members and to the international financial community that the enhanced surveillance procedures, as originally devised, were always intended to be of a temporary nature and henceforth no longer constitute a possible form of Fund involvement. In contrast to earlier years, it would not seem that such a decision would constitute an added difficulty in concluding multiyear agreements, given also the new forms of linkages and assurances developed over time. There are valid arguments in favor of such a position, but in the staff's view it would be unwise to signal an even partial withdrawal of the Fund from its relationship between member countries and their creditors at the present juncture of the debt strategy, and caution needs to be ensured when discussions that assume a continuity of enhanced surveillance may already be under way between members and their creditors. Furthermore, the usefulness and effectiveness of the procedures may become more prominent when the transition to spontaneous market access is more generally reached at some point in the future.

IV. Enhanced Surveillance and External Contingency Financing

In the course of the discussions on the establishment of a Compensatory and Contingency Financing Facility (CCFF), a number of Executive Directors raised the issue of whether contingency financing mechanisms could be attached to enhanced surveillance procedures. Views on the subject among Executive Directors varied, with those opposed to the proposal noting inter alia that external contingency financing was designed to protect an underlying financial arrangement from the Fund, whereas by definition no such arrangement existed under enhanced surveillance procedures. Other Directors noted that the inclusion of external contingency mechanisms would require a fundamental alteration in the procedures and in the very nature of enhanced surveillance, with a judgment by the Board that the underlying program satisfied the requirements for the use of Fund resources in the upper credit tranches. It was noted that this would render the procedures comparable to a precautionary arrangement. On the other hand, some Directors felt that consideration should be given to the use of contingent financing for countries under enhanced surveillance as the procedures involve the evaluation and monitoring of quantified economic programs. The Executive Board agreed that the issue be further examined in the context of

the present review, 1/ so that the implications for enhanced surveillance itself could be properly ascertained; this section has been prepared in response to that request.

Consideration of the attachment of contingency financing to enhanced surveillance needs to be based on the general principles and specific modalities for the compensatory and contingency financing facility recently agreed by the Executive Board. The essential elements underlying the use of contingency mechanisms, which would thus need to be weaved into enhanced surveillance, include: (a) an agreed baseline projection for the calculation of contingent deviations, formulated in the context of a program considered by the Fund to meet the criteria for the use of general resources in the upper credit tranches; (b) adequate monitoring provisions to determine the observance of applicable performance criteria; (c) purchases subject to observance of the program's performance criteria, adjusted by the Executive Board as necessary to take account of the effects of the contingencies; and (d) in the absence of an associated financial arrangement, some specific provisions to determine the extent of access to contingency financing, the phasing of purchases, the duration of the Fund's commitment to contingency financing, and to ensure the symmetric provisions of the mechanism.

The first and most far-reaching element that would need to be adapted concerns the quantified program and the underlying policies on the basis of which the Executive Board approves a member's request for enhanced surveillance. There are clearly substantive differences between a program supported by an upper credit tranche arrangement and a program underlying enhanced surveillance. First, a program supported by a regular Fund arrangement reflects a negotiated agreement between the authorities and management and is based on a detailed formal statement of the economic and financial policies and of the adjustment measures, endorsed by the Fund, which the member will pursue during the period of the arrangement. The quantified program underlying enhanced surveillance represents essentially policies formulated by the member, which need not reflect a convergence of views between the authorities and the staff nor satisfy the Fund's standards of adequacy for programs supported by its own resources, including those provided under external contingency financing. Second, deviations from pre-established performance criteria are a cause for automatic suspension of the member's rights to purchase under a Fund arrangement for use of its general resources, and under the contingency financing mechanism attached to such an arrangement. Until adequate corrective policies are introduced, or a waiver approved by the Executive Board, the arrangement would remain inoperative. In contrast, under current practice, serious divergences of the member's

1/ Final Version of The Chairman's Summing Up of the Discussions on the Compensatory and Contingency Financing Facility Concluded at Executive Board Meeting 88/105, July 15, 1988 (Buff 88/133, 7/15/88).

policies from the stance considered appropriate by the Fund, or departures from the underlying quantitative program, can persist without causing formal prejudice to a member's enhanced surveillance procedures.

A reconciliation of the differing operational and policy aspects of Fund involvement in the two situations therefore would require that the underlying program for enhanced surveillance be made consistent with the requirements of contingency financing as regards conditionality, monitoring and activation. First, with respect to conditionality, the use of the Fund's general resources for contingency financing raises issues with respect to the uniformity of treatment of Fund members. As noted in the Summing Up of the discussions on the CCFF, "for this fundamental principle to be maintained, the conditionality attached to the use of the Fund's general resources under a contingency mechanism must be the same, whether this is in connection with a SAF arrangement, an ESAF arrangement, or an upper credit tranche arrangement." ^{1/} This would of necessity apply also to contingency financing provided under modified enhanced surveillance. The underlying program would need to be sufficiently strong to permit the Executive Board to determine that it entailed conditionality equivalent to that of an upper credit tranche arrangement. It would need to provide an assurance to the Fund about the appropriateness of the member's macroeconomic and structural policies in regard to the achievement of medium-term external viability, and might require actions prior to the approval of contingent financing under enhanced surveillance which appear critical for the effectiveness of the adjustment program. The program would include performance criteria of adequate coverage and appropriate frequency in order to provide a direct link between program implementation and the right to purchase whenever the conditions for the activation of the contingency mechanism are met, or for the activation of the symmetry provisions if relevant. Finally, the program would need to include a reference baseline for the calculation of contingency deviations. As regards monitoring, the semiannual reviews conducted during the interim and annual Article IV consultations that are a feature of the existing enhanced surveillance procedures would be incorporated within a strengthened monitoring framework. In line with the provisions of the CCFF, activation of contingency financing generally would be on the basis of a review by the Executive Board and the purchases would be subject to a member's satisfactory performance under the associated program. Deviations from the established performance criteria would lead to interruption of the right to purchase under the external contingency mechanism, while they need not prejudice the continued exercise of enhanced surveillance in its original connotation. Activation would also depend on assurances that the financing necessary to fill any ex ante financing gaps would be forthcoming, which could require pursuing parallel contingent financing from other creditors.

^{1/} Buff 88/133, 7/15/88.

It is apparent from the above that the observance of the essential elements of contingency financing as approved by the Executive Board, and their extension to enhanced surveillance, would imply a profound change in the nature and concept of enhanced surveillance as understood to date, with the inclusion in the procedure of a number of the elements which had been eschewed at its inception (for the reasons outlined in Section II above), such as formal Fund endorsement of the member's policies, the provision of on/off signals to the market, and a continuation (rather than a phasing out) of the close contacts with a member that accompany Fund lending. 1/ To render enhanced surveillance eligible for contingency financing, it would furthermore be necessary to define a number of technical or operational details. The main difficulties would stem from the absence of an associated arrangement, with the consequent need to define those aspects of contingency financing that are in some way tied to the associated arrangement. These essentially relate to the extent of access to contingency financing, the phasing of purchases, the duration of Fund commitment to contingency financing, and ensuring the symmetric provisions of the mechanism. 2/

V. Conclusions and Issues for Discussions

Early in the cooperative approach to the debt strategy, enhanced surveillance was conceived as an exceptional and temporary procedure to promote MYRAs for the benefit of member countries which had achieved significant domestic and external adjustment, with the expectation that this would ease the transition to spontaneous capital flows in a reasonable time frame. The emphasis has been on the Fund providing timely, candid and comprehensive assessments of debtors' policies as an input for creditors in making their lending decisions. The review of the experience in the application of enhanced surveillance indicates that although many covenants in MYRAs envisaged this procedure, enhanced surveillance has had limited application, mostly because of adverse external developments and slower than envisaged progress by countries in adjusting their economies. The experience of the three cases where enhanced surveillance has been implemented indicates that substantive

1/ Indeed, given the significant modification of the initial concept, the retention of the term "enhanced surveillance" for this configuration could be misleading, both for members and creditors, and a term that is indicative of "contingency financing" could be more appropriate. For the sake of exposition, however, the term "modified enhanced surveillance" will be used hereunder to indicate a situation in which the required elements of contingency mechanisms are built into the procedures and the quantitative framework of enhanced surveillance.

2/ Other than increases in official reserves, the CCFE envisages reductions in the amount of the associated arrangement and/or early repurchases if an earlier contingency purchase had been made.

divergences of views between Fund staff and some of these members on the appropriateness or the desirable speed of the implementation of adjustment policies have continued to persist, raising the issue of the extent to which enhanced surveillance procedures permit the Fund as well as creditors to influence members to embrace policies conducive to external viability.

In summary, there appear to be two main choices to be made: whether enhanced surveillance should be retained and whether modified enhanced surveillance to permit access to contingency financing should be introduced. On the first question, the experience with the implementation of enhanced surveillance to date has undoubtedly given rise to some misgivings and concerns on the part of Executive Directors. It must be noted however that this experience has been relatively limited and subject also to some initial uncertainties regarding the appropriate criteria for the approval and implementation of the procedures. Unless it were thought that the concept of enhanced surveillance contained an inherent weakness which was not remediable, it would appear premature to cease outright this form of Fund involvement and to risk thereby signaling a partial withdrawal of the Fund from the evolving relationship between indebted members and their creditors. Furthermore, it must be noted that the broader conditions required for a greater relevance of enhanced surveillance have not yet materialized. With the delay in resolving important aspects of the debt problem, there has also been a delay in countries reaching the transition stage for which enhanced surveillance was originally envisaged, limiting the intensity of use and the effectiveness of the procedures. The possible provision of this service may however still be considered a part of the cooperative approach to the debt strategy, and could become more generally useful when the transition to spontaneous market access is more broadly reached in the future. It is however important that the concerns raised by the implementation of enhanced surveillance to date be addressed by paying due attention to the criterion of "a strong record of adjustment," shortening the duration in new cases, and considering unilateral termination on the part of the Fund in certain circumstances.

The question of the modification of enhanced surveillance to permit access to contingency financing needs to be examined in the light of the following considerations. First, modified enhanced surveillance as outlined in this paper would abide by the essential principles and modalities of the CCFF agreed by the Executive Board, with the elements of external contingency mechanisms being built into the quantitative framework specified under enhanced surveillance and, importantly, with approval by the Executive Board of the program as one that meets the test of upper credit tranche conditionality. Second, modified enhanced surveillance would thus differ significantly from enhanced surveillance proper, in ways which contrast with the original concept, primarily in requiring Fund approval of the underlying program, strengthened monitoring procedures, and a continuation of the close contacts with a member that accompany Fund lending. This difference would need to be understood and recognized by the financial markets. Moreover, the required

modifications would tend to blur the distinction between enhanced surveillance and other policies on the use of Fund resources. Precautionary stand-bys or extended arrangements have by their nature provided an assurance of access to Fund resources in case of unanticipated need. Third, in the absence of an associated arrangement, the provision of contingency financing would require the definition of a number of potentially complex operational and technical details which could limit interest in the mechanism.

Notwithstanding the above considerations, there may be cases in which the form of "modified enhanced surveillance" could provide a member with a cushion of contingency financing commitments and facilitate relations with creditors, while at the same time avoiding some of the outward appearances of Fund involvement. Nevertheless, given the novelty of the CCFE, it would appear advisable to await for the benefit of the initial experience with the facility before determining its possible application to enhanced surveillance.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

September 6, 1985 - 85/152

**The Chairman's Summing Up of the Discussion
of the Role of the Fund in Assisting Members with
Commercial Banks and Official Creditors
Executive Board Meeting 85/132 - September 4, 1985**

General Remarks

The procedures relating to enhanced surveillance that have been discussed by Directors were developed in response to the need to help members make progress toward addressing their debt problems and improving their relations with their creditors in an orderly manner and in a broader framework.

It was noted by many Directors that by adapting some of its policies, the Fund had played a central role in helping to limit the disruptions associated with the debt crisis and in promoting a normalization of debtor/creditor relations. Most Directors, however, observed that the practice of enhanced surveillance that had developed involved some risks. Some Directors stressed the risk of a possible weakening of Fund conditionality. Others feared that the Fund might tend to become too deeply and too specifically involved in relations with the commercial banks, and that generalized reliance on the Fund's judgment by the international community could affect the Fund's credibility and interfere with the normal functioning of the markets, which should rely eventually on the banks' own assessments. In other words, enhanced surveillance in the view of most Directors should not become a substitute for stand-by and extended arrangements and should not "crowd out" or "dilute" the Fund's normal procedures and transform the institution into a kind of universal credit-rating agency. In that vein, a majority of Directors, while recognizing the usefulness of the practices that have evolved, considered that enhanced surveillance should be used on a limited basis under the guidance and control of the Executive Board, essentially to help promote MYRAs (multiyear rescheduling arrangements), although all MYRAs might not be associated with enhanced surveillance.

Criteria and Procedures

a. Criteria for the adoption of enhanced surveillance

While several Directors insisted on the need for flexibility and on the importance of avoiding too rigid criteria, most Directors felt that enhanced surveillance could be undertaken when the four following conditions are met:

First, at the request of a member country, who must initiate the procedures;

Directors were of the view that authorization to release staff reports should be provided by a general decision pertaining to all cases for which enhanced surveillance is agreed rather than by an individual decision in each case. The reports to be released to creditor banks would reflect only the staff's views and would not contain any reference to the discussions and views of the Executive Board. No amendments to the staff report other than the deletion of references to Board discussions would be made.

e. Involvement of the Executive Board

I understand that the procedure would be as follows: First, request by a member for enhanced surveillance; second, management assesses the case in accordance with the policies agreed by the Executive Board today and determines whether to submit the request for the endorsement of the Board. In cases where the criteria raise delicate problems of interpretation, management would continue to consult informally with Executive Directors at the earliest opportunity.

f. The Colombian case

The view was expressed that the Colombian arrangement had been useful and could be extended to other cases, in particular, cases of prolonged use of Fund resources. However, the majority of Executive Directors considered that the arrangements with Colombia were not a case of enhanced surveillance and that their extension to other countries was unlikely and undesirable. The usefulness of precautionary stand-by arrangements was mentioned by a number of Directors in this regard.

g. Review of the policy on enhanced surveillance

A number of Directors suggested that in view of the need to assess changing circumstances and the possible effects of the procedures for enhanced surveillance on the Fund and its policies, the Board should engage in a periodic review of the policy of enhanced surveillance, with an initial review to be held in about one year.

Yugoslavia: Enhanced Surveillance (ES) Chronology, 1984-88

Late 1984-Early 1985. Yugoslavia's intention of requesting ES discussed with Management and staff; Executive Directors informally advised of authorities' intentions.

April 29, 1985. Executive Board formally informed of the Yugoslav authorities' intention to request ES, on the occasion of request for a new stand-by arrangement.

August 1985. Agreement in principle between Yugoslavia and bank creditors on MYRA covering 1985-88. ES envisaged for period from May 15, 1986 (expiry of stand-by arrangement) through 1991 (consolidation plus grace period of three years).

December 18, 1985. Signing of MYRA with commercial banks. Effectiveness of agreement conditional on approval of ES by March 12, 1986; second part of consolidation covering 1987-88 conditioned inter alia on a finding by bank creditors (based in part on ES reports) that Yugoslavia's policies are consistent with a continuing ability to service its debt.

March 12, 1986. Board consideration of the staff report for the 1985 Article IV consultation (EBS/86/38, 2/19/86) and approval of ES to begin May 16, 1986 through calendar year 1991. Directors stressed the need for consistency of policy and for improved cohesiveness of financial policies, noting uncertainties and lack of mutual support in that area; a number of Directors expressed doubt whether the authorities had the necessary resolve to stick to the discipline that would be necessary to break inflation expectations (SUR/86/21, 3/14/86).

April 17, 1986. Agreed Minute with Paris Club creditors initialed; further approval by creditors subject to satisfactory Board review of monitoring and conditionality aspects of the renegotiation. Two-stage debt relief foreseen, with second stage (May 16, 1987-March 31, 1988) subject to "positive assessment" of participating creditor countries.

May 12, 1986. Board discussion of ES procedures in relation to rescheduling by Paris Club creditors (EBS/86/96, 4/25/86 and SUR/86/40, 5/12/86).

May 13, 1986. Signing of agreement with Paris Club creditors.

August 8, 1986. Board consideration of the first Article IV consultation report under ES (SM/86/176, 7/17/86). Staff appraisal notes that recent measures constitute a clear move away from the use of market signals, raising doubts about the Government's commitment. Executive Directors disappointed at recent course of economic policy. A number of Directors stressed that some of the recent policies ran counter to the authorities' thrust and objectives which had formed the basis for approval of ES (SUR/86/83, 8/14/86).

September 19, 1986. Official creditors considered above staff report; extremely concerned about recent policy developments. Sent letter to authorities noting that full implementation of the program was essential for the second stage of the consolidation.

October 1986. Commercial banks' mission to Yugoslavia. Rather more favorable view of recent developments than reflected in the staff's assessment.

March 13, 1987. Board consideration of staff report for the 1986 Article IV consultation (SM/87/53, 2/20/87). Staff stressed need for persistent application of considerably tighter financial policies, determined execution of structural changes and renewed commitment to the use of market signals. Directors noted a significant weakening of the adjustment effort and urged an immediate tightening of policies. Some Directors urged moving to closer relationship with the Fund; effectiveness of ES depended in large part on authorities paying heed to the conclusions of the Board (SUR/87/29, 3/19/87).

March 30, 1987. Meeting between Yugoslav authorities and official creditors. Second stage of the consolidation to be implemented after consultation on the Managing Director's further assessment of policies presented in Minister's statement.

April 20, 1987. Board discussion of Yugoslav policy statement and of staff analysis (EBS/87/79). In general, Directors believed that a lasting improvement in the economic situation would be contingent upon a further strengthening of policies along the lines suggested in the previous staff report and in Managing Director's summing up (SUR/87/38, 4/21/87).

May 1987. Completion of second stage of commercial bank MYRA covering principal payments falling due during 1987-88.

June 1987. Completion of second stage of official creditors' consolidation, covering principal payments falling due between May 1987 and March 1988.

August 31, 1987. Board consideration of the staff report for the 1987 Midyear Consultation under ES (SM/87/187, 7/30/87 and Supplement 1, 8/27/87). Staff saw as imperative a frank and timely approach to bank and official creditors, supported by an integrated package of adjustment measures. Most Executive Directors strongly advised a closer relationship with the Fund in the form of a stand-by or an extended arrangement; ES had not proved effective in Yugoslavia's circumstances. Record of adjustment under ES had been disappointing (SUR/87/92, 9/2/87).

October-November 1987. Official and commercial bank creditors signal to Yugoslav authorities that any further rescheduling would be contingent on an upper credit tranche arrangement from the Fund.

December 14, 1987. Yugoslav authorities request Fund staff to undertake discussions on a stabilization program that could be supported by a stand-by arrangement.

April 29, 1988. Circulation to Executive Board of Yugoslav authorities' Letter of Intent (EBS/88/89, 4/29/88).

June 1, 1988. Executive Board's consideration of the Staff Report for the 1987 Article IV Consultation and Request for Stand-by Arrangement (EBS/88/89, Supplement 1, 5/7/88 and Supplement 2, 5/27/88). Approval in principle of one-year stand-by; ES suspended for the period of the arrangement.

June 28, 1988. Executive Board's effective approval of the stand-by arrangement on a lapse or time basis (on the basis of EBS/88/89, Supplement 5, 6/24/88).

Venezuela: Enhanced Surveillance (ES) Chronology, 1984-88

September 1984. Agreement in principle on commercial bank MYRA covering 1983-88 maturities. Venezuelan authorities request enhanced surveillance for period through 1997, corresponding to final maturity of rescheduled debt.

May 30, 1985. Executive Board consideration of first Article IV consultation report under enhanced surveillance (SM/85/115, 4/24/85). Executive Directors "welcomed the authorities' proposal for an enhancement of the Article IV consultations and noted that it would involve continuing close collaboration between the Venezuelan authorities and the Fund" (SUR/85/64, 6/18/85). Report not released to creditors as the MYRA had not yet been signed.

December 13, 1985. Executive Board consideration of the staff report for the 1985 Article IV consultation (SM/85/308, 11/15/85). Staff stressed the desirability of a somewhat more restrictive policy stance than that envisaged by the authorities and the need for steps to deregulate the economy. Some Directors noted apparent lack of progress in many areas of structural policy despite earlier recommendations. Staff report not released to creditors.

February 26, 1986. Signing of commercial bank MYRA covering 1983-88 maturities.

July 25, 1986. Executive Board consideration of the staff report for the 1986 Article IV consultation (SM/86/152, 6/25/86). Directors noted that sharp drop in world oil prices had drastically changed outlook. Most Directors held the view that policies included in the authorities' program were not sufficient to deal with the large fiscal and external imbalances, and urged them to adopt promptly a comprehensive program, including modifications in exchange rate and demand management policies coupled with structural reform measures. In light of ES arrangements, a number of Directors expressed concern regarding significant differences of view on appropriate economic policies between staff and authorities; Directors expressed the hope that a convergence of views on economic policies between Venezuela and the Fund would occur soon (SUR/86/74, 7/29/86). Staff report released to creditors.

Oct. - Nov. 1986. Negotiations reopened between Venezuela and creditor banks to modify MYRA in view of the sharp decline in world oil prices.

February 27, 1987. Preliminary agreement on modified MYRA reached with commercial banks' Advisory Committee.

March 2, 1987. Executive Board consideration of the staff report for the 1986 Midyear Article IV consultation (SM/87/22, 1/21/87). Directors stressed that restoration of a viable balance of payments position required the adoption of tighter demand management policies, and also urged the authorities to pursue structural policies. In regard to the ES arrangements, Directors expressed the hope that there would be a further convergence of views between the authorities and the staff on economic policies. It was also noted that when differences existed, Directors found it helpful to have a candid discussion of these issues in the staff reports.

November 13, 1987. Modified MYRA with commercial banks becomes effective; repayment period extended through 1999.

January 6, 1988. Executive Board consideration of the staff report for the 1987 Article IV consultation (SM/87/243, 10/19/87). Staff argued that a significant tightening of policies would be required to achieve the authorities' targets for inflation and the balance of payments. Directors were in broad agreement and expressed hope that Venezuela would soon be able to present a comprehensive economic program for 1988. Several Directors reiterated their concern regarding the differences of views on policy that persist between Venezuela and the Fund and recorded their reservations regarding the effectiveness of the ES procedure. The Venezuelan authorities were urged to begin substantive discussions with the Fund in the formulation of their economic policies and to take into account the views of the Executive Board in the spirit of the ES arrangement.

February 1988. Placing of US\$100 million Eurobond issue.

September 16, 1988. Executive Board consideration of the staff report for the 1988 Midyear Article IV Consultation (SM/88/165, 8/07/88), in which a fundamental correction of financial policies need to be required, with a modification of exchange rate policy, a reduction in the fiscal deficit and a more flexible interest rate policy needed soon if a significantly harsher adjustment at a later stage is to be avoided. Executive Directors agreed with thrust of staff's assessment, and several Directors expressed the hope that the authorities would give greater weight to the views of the Fund in choosing the policy adaptations under consideration (SUR/88/93, 10/26/88).

Uruguay : Enhanced Surveillance (ES) Chronology

July 1986. Agreement with commercial bank creditors on serial MYRA covering maturities falling due between 1985 and 1989. First year of consolidation period to be covered by stand-by; remaining years (1987-1989) to be covered by stand-by arrangement(s) or enhanced surveillance.

July 27, 1987. Board consideration of staff report for the 1987 Article IV consultation (SM/87/101, 5/7/87) and of the Request for Enhanced Article IV Surveillance (EBS/87/156, 7/14/87). Staff expressed view that implementation of the economic program for 1987-88 would constitute a further consolidation of the authorities' adjustment effort. Uruguay's performance under past stand-by arrangement established a good record of adjustment. Directors commended authorities on sustained and successful adjustment efforts (SUR/87/69, 7/28/87). ES approved for period through 1989, corresponding to the end of the consolidation period.

December 24, 1987. Board notified of delay in concluding next Article IV consultation, in order to facilitate a clearer evaluation of performance in calendar 1987 and allow a fuller presentation of policy intentions for calendar 1988 (EBD/87/339, 12/24/87).

March 1988. Agreement on modification to July 1986 MYRA; changed from serial to block and extended to cover maturities due in 1990 and 1991. Provisions regarding ES unchanged.

May 18, 1988. Board consideration of staff report for 1988 Article IV Consultation (SM/88/86, 4/20/88). Staff considered performance during the second half of 1987 as satisfactory, despite some slippages in the fiscal and monetary policy areas. Directors commended the authorities on their continued adjustment efforts and considered as broadly appropriate the authorities' policy objectives for 1988 (SUR/88/41, 5/25/88).

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