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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/128

10:00 a.m., August 26, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	
F. Cassell	
Dai Q.	
C. H. Dallara	
	J. Prader
A. Donoso	
	A. M. Othman
	B. Goos
J. E. Ismael	
A. Kafka	
M. Massé	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
G. Ortiz	
J. Ovi	
H. Ploix	
G. A. Posthumus	
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

C. Brachet, Acting Secretary
S. L. Yeager, Assistant

Also Present

IBRD: J. D. Shilling, Financial Intermediation Services. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; S. M. Schadler. European Department: P. B. de Fontenay, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; M. Allen, C. Atkinson, A. P. De La Torre, M. A. El-Erian, H. Hino, G. G. Johnson, G. R. Kincaid, N. Kirmani, M. Nowak, C. M. Watson. External Relations Department: P. C. Hole, N. Worth. Fiscal Affairs Department: A. H. Mansur. Legal Department: W. E. Holder, Deputy General Counsel; P. L. Francotte, A. O. Liuksila. Middle Eastern Department: P. Chabrier, Deputy Director; M. D. Knight, M. Yaqub. Research Department: M. Goldstein, Deputy Director; E. R. Borenzstein, N. R. Chrimes, M. P. Dooley, D. Folkerts-Landau, Y. Harada. Secretary's Department: K. Wahlstrom. Treasurer's Department: D. Williams, Deputy Treasurer; J. E. Blalock, I.-S. Kim. Western Hemisphere Department: S. T. Beza, Director; E. R. J. Kalter. Bureau of Statistics: J. B. McLenaghan, Deputy Director; R. T. Stillson. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, A. A. Agah, M. Al-Jasser, W. N. Engert, S. M. Hassan, A. R. Ismael, Khong K. N., K.-H. Kleine, M. Pétursson, G. Pineau, A. Vasudevan, K. E. Zeas. Assistants to Executive Directors: F. E. R. Alfiler, J. R. N. Almeida, E. C. Demaestri, Di W., S. K. Fayyad, V. J. Fernández, J. Gold, L. Hubloue, A. Iljas, J. M. Jones, J. A. K. Munthali, D. V. Nhien, C. Noriega, L. M. Piantini, A. Rieffel, S. Rebecchini, S. Rouai, G. Seyler, Shao Z., C. C. A. van den Berg, D. A. Woodward.

1. DEBT SITUATION - DEVELOPMENTS, ISSUES, AND ROLE OF FUND

The Executive Directors considered a staff paper on issues in managing the debt situation (EBS/88/159, 8/4/88). They also had before them a background paper on recent developments in commercial bank financing and restructuring for developing countries (SM/88/172, 8/10/88).

Mr. Ortiz made the following statement:

> Compared with the work done in connection with previous discussions on the debt strategy, the staff paper for this discussion is narrowly focused on modalities of financial flows to indebted countries. While a number of discussions in the past have allowed the Board to examine important aspects of the debt problem and the strategy followed since 1982, it nonetheless remains useful to place this discussion in an adequate perspective. This is all the more relevant since, as the staff points out, in considering this subject last March "[Directors] recognized that in order to counter adjustment fatigue, the authorities in debtor countries must be able to demonstrate that there is light at the end of the tunnel. The latter can be defined as restoring adequate, sustainable growth while... [countries] regain appropriate access to international capital markets on nonconcerted terms."
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> Six years have elapsed since the outbreak of the debt crisis and, unfortunately, there is not even a glimmer of light for most indebted countries. The staff presents a summary of the results of the "balance sheet" of adjustment efforts, noting the major shift in current account positions of highly indebted middle-income countries--equivalent to 30 percent of exports--since 1981, in the face of a cumulative deterioration of the terms of trade of about one quarter over the period 1983-86. The counterpart to this shift in external positions has been a contraction in consumption levels, a fall in investment, and a drastic deterioration in living standards in practically all indebted countries. Although these development is not explicitly mentioned by the staff, the Appendix table included in the report, as well as the figures contained in the most recent world economic outlook exercise, provide a useful complement to the concise balance sheet evaluation presented in the paper.
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> The correction of external imbalances in indebted countries has entailed a corresponding internal adjustment. This adjustment, however, has been all the more burdensome since it has taken place in the context of falling rates of economic growth. Although the experiences have varied across countries, in most of them the transfer of resources abroad has been effected through a contraction in the absolute level of aggregate demand, and particularly of investment. A more systematic consideration of the data for the larger countries provided in the Appendix

table indicates that real GDP in 1987 was below its 1981 level in Mexico, the Philippines, and Nigeria, approximately equal in Argentina, and recorded a positive average rate of growth only in Brazil and Chile. From this vantage point, the maintenance of consumption at near constant levels since 1981--excepting Brazil and Chile, where it rose together with income--implied that transfers abroad came about at the expense of a dramatic decline in investment. Beyond the contraction of GDP, the share of disposable income fell even more pronouncedly, owing to higher government revenues as well as lower real wages. On average, real wages declined at annual rates of close to 2 percent in Chile and the Philippines; the fall in Mexico approached 5 percent annually. Only in Argentina and Brazil did real wages rise slightly throughout the period 1981-87.

In sum, the correction, and in some cases the redress, of external imbalances in most indebted countries has been made possible by a severe deterioration of living standards. Furthermore, the long period of depressed investment and the current status of financial arrangements, which envisage a continued negative resource transfer, do not allow us to expect a resumption of growth in the medium term. The room for maneuver for policymakers is practically nil, and yet today the main debt indicators of these countries is worse than at the outset of the debt crisis. For the group of countries classified by the World Bank as highly indebted, the ratio of total external debt to GDP rose from 37.1 percent in 1981 to 60.8 percent in 1986. Debt service ratios also rose significantly during the period. Considering both the overall deterioration of the internal living standards and of the debt indicators, it may be concluded that the creditworthiness of this group of countries has eroded even further. The marginal improvement of some of the debt indicators in 1987 and 1988 has not been significant enough to entertain any hopes that access to the international financial markets is within reach in the near future. In this fundamental sense, then, the debt strategy has failed.

An issue which needs to be emphasized in these discussions is the effect of the debt overhang on the ability of governments to implement stabilization policies and structural reforms that are perceived to be sustainable. In his speeches on the debt situation, the Managing Director had repeatedly mentioned that an essential element for the alleviation of debt problems is the implementation of strong adjustment programs and has stressed that the main responsibility lies with the debtor countries themselves. The report also mentions that regaining growth and creditworthiness "depends upon the restoration of confidence on the part of both foreign and domestic savers, including a return of flight capital." Yet, the implications of the existence of excessive debt--and the discounts prevailing on the secondary market indicate that a debt overhang is clearly perceived by the markets--on the probability of success of adjustment programs--a point which this chair has stressed in previous occasions--continues to be given insufficient attention in these discussions.

It is a fact that most stabilization programs attempted during the past six years in heavily indebted countries have failed. It may be argued that, in most cases, the main culprit for the failure of adjustment programs can be traced to insufficiently strong actions, to problems of coordination, or to the lack of political will in the implementation and follow-through of the adjustment measures. But it is also true that unfavorable external shocks--such as adverse shifts in the terms of trade--and the difficulties associated with the debt overhang have made adjustment extremely difficult, even in those cases where the authorities are fully committed to the implementation of the program. One of the most relevant examples of these difficulties is given by the fiscal dimension of the debt problem, which can be summarized as the need to effect an internal resource transfer to the public sector in order to service the foreign debt--a problem which normally entails inflationary pressures and the compression of investment; and the continuous fragility of public finances, reflected in the uncertainties associated with the capacity to service domestic and external indebtedness and the possibilities of eliciting financial flows. These uncertainties imply that domestic and foreign investors will demand high rates of return--requiring, in turn, the payment of low real wages--with the consequence that the sword of Damocles of capital flight is perennially threatening to disrupt debtors' stabilization efforts while at the same time it serves as a convenient target for creditors' finger-pointing at "insufficient adjustment efforts" as an additional reason for withholding credit.

The Managing Director has also mentioned that some sort of a "quiet revolution" is taking place among national authorities of indebted countries. It is gradually becoming more widely acknowledged that leaner public sectors, more open trade and payments systems, and less regulation of domestic markets are essential elements of a new development strategy that marks a clear departure from the past. But for this conceptual evolution of development strategies to be effectively implemented in a manner which is perceived to be sustainable, it is essential to reduce the overall level of macroeconomic uncertainty, which depends in no small measure on the possibilities of securing adequate financing flows. A financial horizon which investors regard as sufficiently clear over the medium term seems to be a necessary condition for the resumption of investment and growth. In our view, the Fund has an important role to play in helping to establish such a medium-term perspective.

The title of Section II of the staff report, "Adequacy and Modalities of Financing Flows" is somewhat misleading, as it deals only in a tangential manner with the question of adequacy--through the stylized medium-term scenarios--while focusing mostly on different modalities. The figures included in these exercises are also somewhat confusing. Case I situations represent countries which have a strong balance of payments outlook, but for which growth remains insufficient to provide employment opportunities for a growing labor force. Case II situations reflect countries for which "adequate growth rates are postulated," but for which there remains a financing gap. Yet, the medium-term growth rates for Case I countries are actually higher than those for Case II countries. Thus, if the assumptions regarding what constitutes acceptable growth rates and the relevant characteristics of the hypothetical countries, among others, are not made explicit, the figures included in the tables are difficult to interpret.

Moreover, it is not easy to distinguish between Case I and Case II situations, since countries remain vulnerable to external shocks that can have a drastic impact on the medium-term balance of payments outlook, resulting in frequent cross-overs between the two situations. I realize that these are stylized cases, and that the staff aims at highlighting differences that suggest the appropriateness of the case-by-case approach. These examples also serve to illustrate which financial modalities appear to be more adequate depending on the underlying situation of the balance of payments and growth prospects. From this perspective, these exercises serve a useful purpose, even if it is difficult to imagine a stable classification of indebted countries according to the proposed criteria.

The staff suggests that Case I countries would benefit from utilizing the available debt reduction techniques, which, given a basically sound balance of payments situation, should allow for faster growth to the extent that resource transfers are diminished. Case II situations may require a more fundamental overhaul of the country's balance sheet through extensive Bolivian-style debt buy-back arrangements or--more imaginatively--debt exchange operations of the type normally utilized in debt restructuring with private corporations. I basically agree with this approach, with two caveats. First, as the staff recognizes, there are limits to the extent to which debt reduction operations can be applied. Those that require up-front cash are naturally limited by the country's own resources or credit possibilities. In contrast, debt-equity swaps have a number of drawbacks, which are mentioned in the report. In addition, a number of legal, fiscal, and regulatory considerations place important constraints on the breadth and scope of debt reduction operations. The staff's comments in this regard are certainly relevant, as they point to inconsistencies between the actions of regulators and fiscal authorities of creditor countries and the further development of the menu approach. These inconsistencies explain a good deal of the delays, frustration, and fatigue associated with the negotiation process. The second caveat refers to the point already made regarding the inherent fragility and instability of the balance of payments outlook, which serves as a basis for the distinction between Case I and Case II situations. With respect to the staff's comment on Case II situations--namely, that "where no early return to the market is in prospect and the level of bank debt is small, a relatively large-scale buyback may be possible and desirable...,"does this imply that Case II-type solutions should be restricted to small debtors? I can readily see how cases with smaller debt levels may be more manageable, but that should not preclude the consideration of this approach for larger debtors.

As regards future developments, the staff envisages furthering the possibilities of blending new money with debt reduction instruments. While conceptually there should be no conflict in pursuing this approach--as suggested by the concentration of claims on larger banks--it is not easy to see in practice how those creditors who apparently wish to hold their claims at face value can be persuaded to finance the exit of those who want "out," in the absence of a concerted approach with creditor governments and multilateral institutions. There are indications that we may be moving toward the worse case scenario; namely, severely limited possibilities for debt reduction operations and increased reluctance by money center banks to engage in new lending operations with a large float of "free riders."

In the present circumstances, the catalytic role of the Fund should be reassessed and widened. The introduction of the enhanced structural adjustment facility constitutes a major initiative on behalf of low-income debtor countries, and has been recently reinforced by favorable actions in the debt front on the part of official creditors. But for the middle-income debtor countries, the revitalization of the extended Fund facility--a potentially basic instrument for the Fund's participation in the debt strategy--did not go far enough. Nonetheless, I agree with the basic thrust of the staff's view regarding future Fund involvement. Especially important will be the preparation of medium-term scenarios that assess the realistic possibilities of combining debt reduction and new money from creditors, while involving the Fund's own resources. The Fund needs to play a more active role in broadening the possibilities of debt reduction through debt reconstruction mechanisms that elicit the direct participation of creditor governments. As mentioned earlier, it will be essential to secure a clear financial horizon in the medium term for the resumption of economic growth.

Mr. Posthumus made the following statement:

The staff paper is a valuable and rich contribution to the evolution of the debt strategy as well as a codification of the evolution taking place in a strategy which is, after all, market based. Assuming that the discussion today is also a valuable contribution, we have here the inputs for a document to be submitted to the Interim Committee. That document will probably be the summing up of our discussion; I suggest that this summing up will not immediately follow today's Board discussion, because I doubt that the sense of this discussion can be summarized during the discussion.

Recently, it has not been easy for supporters of the existing debt strategy--including myself--to defend it on the basis of its results, with the exception of its contribution to avoiding an international financial crisis in the first half of the 1980s. It is too obvious that for some debtor countries, adequate growth rates are not compatible with growing out of debt in the near future, as illustrated in the Case II situations set out in the staff paper. Because this fact is so obvious, there have been many debt relief proposals. Many of these proposals have suggested generalized solutions for the debt problem, and they were presented as alternatives to the existing debt strategy. The case-by-case approach, however, can well be combined with debt relief or debt reduction. In fact, private creditors joining in debt reduction operations will only do so on a case-by-case, rather than an across-the-board basis. In its presentation of the debt strategy and of the role of the Fund in that strategy to the Interim Committee, the Board should make clear that the existing debt strategy is a case-by-case, market-based strategy which can, and where appropriate should, include debt reduction. That will spare us unnecessary debate, and it will help focus on issues such as the menu of options, and debt scenarios, because these are the instruments for identifying and attaining appropriate debt reduction.

What is the role of the Fund in this environment? The staff paper mentions three instruments: the new policy approaches adopted by the Board--extended Fund facility, enhanced structural adjustment facility, compensatory and contingency financing facility, medium-term financing plans, and medium-term scenarios. As long as the debtor country concerned can, after adjustment, combine sustainable growth with growing out of debt, there is no real problem: the Fund can then support adjustment policies, and debt can be serviced. However, if debt can only be serviced at the cost of unsustainable low-growth scenarios, problems arise. In that situation, the proper role for the Fund is to stick to its primary task, namely, to support strong adjustment programs that lead to sustainable growth. This year the Board has not only adopted policy approaches that improved the Fund's ability to support countries' efforts, but it has also drawn a clear line; namely, there should be reasonable certainty that the adjustment program and the Fund's support lead to a sustainable economic situation in the debtor country. A continued ability of the debtor to service its reduced debt is a necessary but not a sufficient condition. There seems to be a growing awareness that there are cases where only a certain amount of debt reduction can, on the basis of a strong adjustment policy, lead to a sustainable situation. In that connection, I wonder whether the staff still is of the opinion that debt reduction may be, in part, temporary, in the sense that creditors might later share in the dividends of successful adjustment? The Fund can play a useful role in assisting parties--debtors and commercial creditors--in identifying the problem and in finding solutions. The staff's identification of three different country situations is illustrative of this awareness, though perhaps somewhat theoretical: but this should be a case-by-case approach, of course. As far as financing is concerned, I continue to think that the Fund takes great risks in providing funds to highly indebted countries. If commercial banks have increasingly indicated unwillingness to continue general purpose medium-term finance and if debtors question increasing indebtedness--as indicated in the report on commercial bank financing--then apparently parties are ready to look for other solutions: increased Fund financing to these countries solves nothing and may lead to locking-in of its resources.

There is one element in the section of the staff paper on the role of the Fund which I hesitate to support; namely, that there is a role for the Fund in helping a country to devise a medium-term financing plan that optimizes market opportunities. How far can the Fund go, and how much expertise does its staff have with respect to understanding market opportunities? Can the Fund know the concerns of the financial and regulatory authorities in all the different creditor countries? Is it not sufficient that the banks themselves know this? And would the Fund be tempted not only to devise medium-term financing plans that optimize market opportunities, but also to step into implementation of those plans? This question reflects my doubts about the appropriateness of our financing role where the interest rate contingency of the compensatory and contingency financing facility is concerned, and where the Fund may change the conditions for commercial bank financing for certain debtor countries; no other facility of the Fund has this potential effect.

Extending his remarks, Mr. Posthumus said that his Dutch authorities wondered whether the efforts described in the background paper to introduce interest rate concessions and debt forgiveness into Paris Club operations was desirable. They would prefer instead to see the debt problems of the poorest countries alleviated through increased aid flows to those countries. They also wondered whether allowing Paris Club creditors to choose from among various financing options might not jeopardize the Club's operations by raising questions of burden sharing.

Mr. Finaish made the following statement:

It has been some time now since it became clear to all concerned that the debt problem was much more than a question of liquidity that could be dealt with through belt tightening for a few years. This recognition was a welcome development in the debt strategy, as it implied a more realistic and sustainable adjustment framework with more emphasis on exports and growth, and on adequate financing to ensure the necessary level of domestic absorption. At the same time, however, this recognition of the protracted nature of the debt problem, and the fading away of the crisis atmosphere which prevailed in earlier years, have made it increasingly more difficult to elicit new lending from creditor banks. The strengthened balance sheets of banks--through reserves, provisions, and other means--have also contributed to commercial banks' reluctance to increase their exposure to debtor countries.

To a large extent, the recent developments in the relations between debtor countries and creditor banks, and the proliferation of new financing instruments that are more in tune with market realities, can be viewed as a natural consequence of the evolving debt situation. To the extent that these market-related mechanisms involve a reduction in the stock of debt, and thus in future debt-servicing requirements, they constitute a welcome shift in the management of the debt situation.

The question, however, is whether these mechanisms will substitute for the reduced availability of new money in a manner that insures the financeability of debtor countries' adjustment programs, which is a central requirement for the success of the debt strategy.

Of course, there are other elements which are equally crucial for the success of the strategy, including firm implementation of adjustment and reform policies by debtor countries, and a favorable external environment. There are obviously great uncertainties in this respect, not least of which are the not so favorable prospects for world trade and international interest rates. There is also the question of the medium-term growth prospects of debtor countries in view of the large investment cutbacks that have taken place in the last six years. These are obviously critical issues, but I will not go into them today.

On the question of financing, it could be argued that future developments in the menu approach, including new-money financing, as well as debt-reducing and market-related mechanisms, will be shaped by market realities and thus should be left to the parties concerned. However, there are at least two reasons that argue against a hands-off approach.

First, as the staff paper indicates, there seems to be an excessive focusing on short-term interests by commercial banks; and more important, individual bank decisions may not reflect the externalities associated with particular courses of action. Thus, what may be in the interest of creditors as a group may seem detrimental--or at least not as beneficial--from an individual bank's standpoint. Obviously, the problem of free riders is a serious one, and unless the banking community is able to deal with it effectively, banks' behavior may continue to be suboptimal.

Second, indebted countries constitute a significant portion of the world economy. Thus, their economic performance and external viability can have an important impact on global welfare, and more specifically, on global external imbalances. For example, from 1980 to 1986 the U.S. trade balance with Latin America turned from a surplus of about $2 billion to a deficit of $13 billion. As long as debt service continues to absorb a large share of debtors' export revenues, their imports will not revive, and global economic growth will suffer.

Thus, there seems to be a good basis for the argument that the existing scope for voluntary debt-reducing mechanisms could be enhanced by steps to internalize the positive externalities associated with such mechanisms, both within the creditor community and the world economy as a whole. While some of the ideas that have been proposed, such as the establishment of a centralized debt-discounting facility, have not received enough support so far, there are other, less radical steps that could be helpful. For example, the regulatory, accounting, and tax provisions in creditor countries can be used to increase the incentives for banks to engage in certain undertakings that they would otherwise be reluctant to do on the basis of narrow short-term interests. Although there has been a tendency toward more flexibility with respect to some financing innovations on the part of regulatory authorities, a more active policy would seem to be called for. In this connection, while I agree with the staff that it would not be desirable to rely on regulatory actions that conflict with economic and market fundamentals, equal caution is called for when viewing economic and market fundamentals in a narrow manner which ignores the market's inability to capture the feedback effects of actions by individual banks and the potential costs and benefits to the global economy of such actions.

Also, I continue to be somewhat unclear on the rationale for the Group of Ten's recently published capital adequacy rules, which are based on a two-tier risk assessment and do not seem to allow for adequate differentiation and changes in creditworthiness over time. It would be useful if the staff could provide some clarification of these rules and their potential impact on banks' behavior.

What is missing from the staff paper is any analysis of the debt situation of middle-income countries whose debt is owed mainly to official creditors. While the emphasis on commercial debtors is understandable, a number of middle-income debtors face the particular situation of not being able to benefit from the type of relief provided to low-income countries and their debt, although mostly owed to official creditors, is not necessarily concessional. The prospects of reducing the stock of debt in such cases cannot benefit from the market discounts which exist in the case of commercial credit. It would be useful to include some analysis of these issues in future staff papers on the debt situation.

While, in broad terms, the role which the Fund can and should play in the management of the debt problem remains essentially the same, the ongoing evolution of the debt situation will require that the Fund stand ready, within the limits of its mandate, to adapt its policies when such adaptations are judged to be useful. A number of such adaptations were undertaken in the recent period, including the establishment of the enhanced structural adjustment facility, the revitalization of the extended Fund facility, the introduction of contingency financing, and according more weight in Fund-supported programs to growth objectives. In the period ahead, further adaptations may well become necessary in the light of changes in the debt situation. In particular, innovations in the modes of bank financing may necessitate another look at Fund policies and practices, for example, with respect to financing assurances and the concept of critical mass. Of course, the willingness of the Fund to extend its financial support to members' adjustment and reform programs remains an essential aspect of the Fund's role.

More broadly, the Fund, as an international cooperative institution responsible for the well-being of the international monetary system, remains uniquely placed to look at the debt problem from the standpoint of global welfare, taking into account the interests of all its members. In that context, the Fund can contribute positively to a better understanding of the implications of developments or actions by the various parties to the debt strategy, taking fully into account the interdependence of the world economy and the multifaceted nature of the debt problem.

Mr. Ismael made the following statement:

The many positive developments in the debt situation are welcome. Contributing to this improvement was the successful adjustment of the current accounts of the highly indebted countries, although the severe compression of domestic demand and imports will erode their future growth potential. There is also evidence of important shifts in these countries to address past policy mistakes and prevent their recurrence. At the same time, the expansion of the menu of financing options, debt reduction instruments, and rescheduling with longer maturities at lower spreads has increased the flexibility for both creditors and debtors to manage the debt problem. Official creditors have also shown greater willingness to provide increased financing. The recent further easing of rescheduling terms and the increase in commitments of official development assistance (ODA) to the low-income heavily indebted countries under the Toronto Economic Declaration of June 1988 is particularly welcome. The recognition that the existing stock of debt has to be reduced in order to normalize financial relations between debtors and creditors was an important step forward in the evolution of the debt strategy.

Despite this progress, however, we cannot afford to be complacent. The latest report on the world economic outlook has rightly emphasized that countries with debt-servicing difficulties will continue to face debt burdens at the end of the decade that are still considerably larger than they were in 1982, in spite of an expected improvement based on relatively optimistic assumptions, including the continuing steady growth of world trade and stable terms of trade. At the same time, these countries remain highly vulnerable to adverse external developments and domestic policy failures, especially with the onset of "adjustment fatigue." They could also pose a renewed threat to the world financial system, in view of the recent rise in international interest rates and falling oil prices. Of particular concern is the increasing reluctance of private creditors to extend new financing to indebted countries in adequate amounts to revive sound investment, which is crucial for sustained growth-oriented adjustment.

A continuation of the case-by-case approach, with the slow evolution of the appropriate market instruments in each particular circumstance, assumes that there is a luxury of time to manage the debt problem. This assumption might have been appropriate in the early stages of the global cyclical upswing, but it leaves too much to chance in the present mature stage of the current expansion. The six-month London interbank offered rate (LIBOR) has increased by more than 200 basis points since February, and indications are that it will rise further. In addition, the market innovations have not reduced sufficiently the overall debt burden, despite a restructuring of debtors' balance sheets. Nor have these innovations contributed to a strong revival of investment in the highly indebted countries.

At previous discussions on the debt strategy, this chair has expressed the view that the present strategy was appropriate only for the moderately indebted countries. For the heavily indebted countries--where the possibility of growing out of debt is remote--I continue to believe that the debt overhang and debt service is so large that it would be difficult to convince creditors and investors, including residents of indebted countries, to increase their exposure. For such countries, some form of an international debt facility to reduce the debt overhang would be essential to impart confidence to both creditors and investors regarding debtors' ability to grow out of debt within a reasonable time span.

In this connection, I must express disappointment that the staff has not completed the study on Mr. Sengupta's proposal for an international debt facility to help reduce, on a case-by-case basis, the debt overhang of those highly indebted countries willing to undertake strong adjustment. I urge management and the staff to expedite the study so that the Board can discuss the subject without prejudging the likely political support for such a facility.

Market-based solutions for debt reduction and debt relief can be facilitated by better coordination among the creditor countries to improve the regulatory, accounting, and tax environment for market innovations. At present, the maze of regulations and practices in different countries gives rise to considerable uncertainties that have been removed only on a case-by-case basis. I agree with the staff that greater consistency and predictability in regulations across countries will encourage continuing innovations in the menu approach. I wonder if the Fund can promote such coordination in the Interim Committee by suggesting how regulations could be made more uniform.

In particular, the Fund could suggest how the Group of Ten's new capital adequacy rules could be improved in areas where they have an impact on the debt strategy. By regarding all loans to developing countries as bearing the same credit risk, these rules do not encourage recognition of improvements in a country's creditworthiness. Therefore, they retard the country's re-entry into the market, apart from their inherent--and objectionable--bias that any country belonging to the Organization for Economic Cooperation and Development (OECD) is a better credit risk than even the best-managed developing country.

I doubt that interest rate hedges, caps, and similar instruments can provide more than limited protection to debtors, and then only when market developments are perceived correctly. The dilemma in using such instruments is this: because of their cost, effective reductions in debt service can only be achieved if these instruments are used for limited periods, and when market trends are correctly read as adverse. To be prudent, however, one should really hedge all the time. But the long-term costs of continuous hedging may be greater than the savings achieved. Therefore, I wonder whether the staff could explain how hedging and interest caps could be cost-effective for an entire floating rate debt portfolio over a sustained period of time.

I support the staff's proposals on the role of the Fund in an evolving and increasingly complex market situation. Helping national authorities to construct medium-term scenarios and to devise medium-term financing plans would be really useful. In addition, I agree that the Fund should consider again the concept of "critical mass" in those situations depicted by the staff.

Although market-based menu options are to be encouraged, the debt strategy remains a cooperative effort by all parties concerned. It is worth reiterating that industrial countries need to sustain noninflationary growth, open their markets to developing country exports, and promote an environment conducive to lower interest rates. At the same time, debtors need to sustain adjustment to increase resource mobilization and efficiency in resource use, while creditors should provide new financing for productive investment that supports growth and exports in debtor countries. Regrettably, this last element continues to be lacking in the debt strategy.

Mr. Kafka made the following statement:

The staff paper is extremely interesting and contains a wealth of ideas. Its message is not presented aggressively, perhaps because it is intended as a follow-up to the previous report on this subject. However, if I understand it correctly, the message seems again to be that the debt problem is entering a particularly challenging phase in which the Fund must be ready to experiment with new--or at least a new mixture of--approaches. If that is the thrust of the paper, I am in full agreement.

The staff draws our attention to the fact that a tremendous amount of current account adjustment has already taken place among the highly indebted middle-income countries. It also stresses that this adjustment has been achieved at the expense of growth rates that are still unsatisfactory and reductions in investment ratios that are extremely burdensome and bode ill for the economic future of the indebted countries. No one will deny the basic importance that must be attached to the need for effective implementation of comprehensive economic programs by the debtor countries. But the staff seems, by comparison, to downplay the simultaneity that is required of the two other ingredients of the so-called debt strategy, namely, the improvement in the international economic environment and the provision of external financing in some form, whether as new money or other methods of relieving the transfer burden.

I would like to be reassured by the staff that it is also aware that large-scale private capital flows to developing countries, particularly in the form of syndicated bank loans, have ended for the time being and cannot be expected to resume. Certainly, some developing countries will continue to be able to find other means of private external finance, but it is doubtful that any of the highly indebted countries will be among them. Therefore, the question to be faced is not only how to replace the private external flows that were available in the past but unlikely to be available in the future by other private flows, but also, how to expand--even more than is envisaged at present--official flows not only to low-income but to middle-income countries. At the same time, where concerted private flows of new money can still be made available, it would be helpful if they too, like rescheduling, were to be subject to multiyear arrangements.

A particularly bothersome recent aspect of the debt problem is the use of interest arrears as a financing technique. This practice merely underscores the need to find new sources--not necessarily only private sources--of additional finance, not only for low-income but for middle-income indebted countries. The staff's three stylized cases illustrate the difficulties of setting growth objectives that are both adequate for the indebted country and compatible with the supply of finance that can be expected, whether finance is in the form of new money or some sort of debt relief. In this connection, I would like to mention once again the technique of temporary but definitive reductions in, rather than capitalization of, parts of interest payments due--a matter which is of particular interest now that interest rates are on the rise again. Such temporary but definitive relief may have a wider applicability than the buy-back method. Among other particularly suggestive points raised in the staff paper is the problem of regulatory, accounting, and tax provisions that limit the use of the menu of private financing or debt reduction options that might otherwise be available. In this connection, the Group of Ten's new rules on capital adequacy are likely to create major difficulties for the provision of private finance.

The role of the Fund in the debt situation should certainly not diminish in the foreseeable future. A withdrawal--even a partial or temporary withdrawal--of the Fund from involvement in the debt situation would be difficult to justify, nor can the Fund avoid running risks in its involvement. Thus, the Fund should not refrain from offering assistance in cases where debtor countries cannot eliminate financial arrears under reasonable conditions because banks, for one reason or another, refuse to cooperate. Moreover, I find particularly suggestive the staff's statement that "the Fund on occasion may need to support a member country on the basis of financing assurances that should be evaluated in more qualitative [rather] than in the quantitative terms of the past, although such an evaluation would be no less demanding." The phrase may be slightly sibylline, but it will have to be taken to heart. The reference to cases "where debt reduction by some creditors is blended with new money provisions by others" is also particularly interesting.

Mr. Prader made the following statement:

The staff has appropriately focused its analysis on the contributions that menu-based techniques can make to improve a persistently worrisome situation. Cost-benefit analysis of those techniques and some framework for assessing what blend of new money and debt conversion is most suited to the specifics of each case are both highly needed to give guidance to debtors and creditors alike.

Experience and analysis so far suggest that debt reduction cannot be considered as a general solution capable of replacing the present strategy, which is based on moderate additional financing to support a country's growing-out-of-debt strategy. Both Mr. Ortiz's and Mr. Posthumus's statements give the impression that there is no basic disagreement among us on this proposition. Cash requirements to finance outright debt repurchases are clearly too high to be envisaged on a large scale. Efforts to minimize these outlays by converting, instead of repurchasing, outstanding debt still involve sizable cash requirements to collateralize the converted debt and have shown only limited influence on the markets' perception of a country's creditworthiness.

Suggestions have now been made for reinforcing the attractiveness of debt conversions by collateralizing interest obligations on the converted debt. While I agree with the general proposition that the reimbursement of interest payments is of greater concern than the reimbursement of capital, I could also envisage the alternative solution in which the debtor improves his ability to raise new money by collateralizing the interest obligations due on his new debt, while leaving the nature of his outstanding debt unchanged. In any case, it appears that many efforts have so far been devoted to increasing the attractiveness of debt reduction schemes while little or no ideas have been submitted to improve the incentives for new lending.

Another point which is not explicitly dealt with in the staff paper, but which should perhaps be submitted to the Interim Committee for consideration, is that the experience with the menu approach also shows that debt conversion arrangements are more easily negotiated for those countries with a satisfactory record of adjustment. This fact strongly suggests that sound policies in the debtor countries are still considered their most valuable collateral by the banks, which is in full compliance with the present strategy's basic principles. In sum, conversion techniques are to be viewed and promoted as useful interim steps capable of slowing the pace of debt accumulation, within the framework of a general strategy of growing out of debt.

I welcome the staff's initiative to start elaborating scenarios that will permit an assessment of what blend of new money and debt reduction is most suited for different categories of debtors at each stage of their external adjustment process. Clearly, this is an area where the Fund can provide major guidance and support, based on its expertise with medium-term scenarios for countries' balance of payments prospects. Further reflection on the optimal financing solutions suggested by different patterns of growth and current account prospects is still needed, as has been extensively demonstrated by Mr. Ortiz. To give another example, for the Case I countries identified in Table 3 of the staff paper--those with a combination of low growth, no financing gap--I fail to see why debt reductions would a priori be more advisable than the moderate accumulation of new debt. Moreover, would the absence of a financing gap not remove all incentives for the banks to engage in any debt reduction scheme at conditions below the debt's face value?

Finally, the staff has also posed the question: how will a more systematic use of menu-based approaches affect the Fund's role with respect to the requirement of appropriate financing assurances? Before addressing the issue of quantitative versus qualitative assessment of financing assurances in more detail, it is clear that, here too, more analytical work is needed to clarify our understanding of the ultimate balance of payments impact of each of the menu techniques under consideration. While most of those techniques may have a favorable effect on the structure of the country's debt profile and therefore deserve adequate promotion, what matters in the final analysis is their impact on the country's residual financing requirement. In that connection, the effect of debt conversions on the financing gap seems to be equally as quantifiable as new money contributions; perhaps the staff could comment on this point. In any case, if qualitative assessments are needed, they should be dealt with in full compliance with the present strategy, namely, on a strict case-by-case basis and with due regard to the country's adjustment record.

On Mr. Posthumus's reservations about the Fund's possible role in the design of a medium-term financing plan that optimizes market opportunities, I share his doubts about the expertise of the staff. Advice on optimal market strategies should probably be provided by other more qualified institutions, such as the International Finance Corporation. The Fund has a valuable and important role to play in pointing out the medium-term balance of payments financing options and needs of its member countries.

Mr. Yamazaki made the following statement:

This discussion provides a useful opportunity not only to examine the progress that has been made, but also to consider the further evolution of the debt strategy. I would like to focus primarily on three issues: the current debt situation; the menu approach; and the role of the Fund in the debt strategy.

The international debt problem has been more protracted than had initially been expected, although there are some encouraging signs, such as the decline in debt service ratios. The economic performance of indebted countries has not improved sufficiently, even though the intensified policy coordination among industrial countries has sustained the noninflationary growth of the world economy. Nevertheless, the developing countries' total outstanding debt has continued to rise, which illustrates that the difficulties facing indebted countries have not yet abated.

However, it is worth reiterating that a recurrence of the debt crisis has been successfully avoided through the implementation of the case-by-case approach since 1985. The growth-oriented adjustment of indebted countries has been supported by new money from private banks and international financial institutions on a case-by-case basis, although the pace of adjustment in these countries has fallen short of expectations. It is my firm belief that there is no sweeping solution for the international debt problem. A steady effort, based upon the case-by-case approach, is the only key to sustaining the confidence of both creditors and debtors with a view to resolving the problem, as well as encouraging creditors and debtors to make further efforts. It would be neither appropriate nor realistic to try to solve the debt problem by adopting a global or generalized strategy.

However, adjustment fatigue is a main source of concern. The fatigue prevailing not only in the indebted countries, but also among creditors, especially the commercial banks, underscores the importance of maintaining the momentum of the debt strategy. Nevertheless, the fundamental basis of that strategy should be the strong implementation of an effective adjustment policy aimed at restoring the debtor country's ability to service its debt. The discounting or writing-off of debt alone cannot provide an appropriate solution.

As for the menu approach, it is essential to enhance capital flows from private banks, international institutions, and donors so as to support the economic adjustment efforts of indebted countries. The menu approach, which evolved as part of the case-by-case approach, will also contribute to these efforts, although new money will continue to play a major role in providing the needed cash flows to indebted countries.

The staff paper emphasizes the growing tendency among banks to reduce their exposure to indebted countries. It should also be pointed out that private banks have continued to provide cash flows to those countries which implement appropriate economic policies and adopt a cooperative approach to the resolution of their debt problems. Also, because the various options in the menu carry some limitations, they will not lessen the need for new money; they should, instead, be broadened and deepened as a complement to new money.

Central to the success of the debt strategy is the emerging shift of debtor countries toward a cooperative approach. Care must be taken not to discourage this favorable shift in attitudes, for example, by rigidly advocating the menu approach. In this connection, it is also necessary to link the options in the menu with the implementation of an adjustment program. I fully concur with the staff on the importance of phasing financial support with the monitoring of policy implementation. It should also be emphasized that any option in the menu should be market based and should not transfer risk from the private banks to the international organizations or to creditor countries.

With these caveats, I strongly endorse the strengthening of the menu approach so as to ensure the needed capital flows to indebted countries. The development of the menu of options would help to create the impetus for further efforts by both creditors and debtors. Moreover, the diversified interests of creditor banks also illustrate the need for further exploration of the menu approach.

On the role of the Fund, I am in basic agreement with the thrust of the staff paper. I would only emphasize that my authorities have strongly supported a central role for the Fund in the debt strategy because Japan's historical tradition favors close collaboration with the multilateral institutions, especially the Fund, rather than bilateral approaches, to resolve the international debt problem. In this context, my authorities are willing to seek ways to strengthen the debt strategy centered on the Fund, in addition to contributing substantially to the increase of quotas in the context of the Special Quota Increase, as well as the Ninth Quota Review.

Mr. Massé made the following statement:

There have been some encouraging developments in the debt strategy in the past few months, most notably the continuing evolution of market-based mechanisms and important initiatives at the official level, particularly for the poorest countries. In addition, the most recent report on the world economic outlook points to some encouraging signs with respect to the debt problem. In particular, despite recent increases in international interest rates, an improvement in the debt burden of countries with debt-servicing difficulties is projected over the next few years.

Nevertheless, many countries continue to face substantial debt burdens despite considerable external adjustment, while many banks are reluctant to provide adequate financing. In addition, the improvement projected in the recent report on the world economic outlook is insufficient to suggest that a resolution of the debt problem is in sight. While average GDP growth has improved over the last six years, current and projected growth rates are generally insufficient for many of the debtor countries to grow out of debt. Under these circumstances, the debtors remain vulnerable to a deterioration in their external environment. And, as Mr. Ortiz has noted, perhaps somewhat more dramatically, the light at the end of the tunnel remains elusive.

Six years after the onset of the debt crisis, it is evident that there is no easy solution to the ongoing problems. But, the broad requirements of any solution remain the same. In this connection, it is widely accepted that the only viable path to the restoration of normal debtor-creditor relations is through the recovery of growth, propelled by medium-term adjustment programs in debtor countries, a supportive external economic environment, and adequate balance of payments financing. My authorities continue to feel that the key to a lasting improvement remains the sustained implementation of strong adjustment programs on the part of the debtors.

While a number of debtor countries have undergone substantial adjustment in their external accounts, too often there has been insufficient support from fiscal, monetary, and structural adjustment. Most recently, there has been a worrisome acceleration in inflation owing to lax financial policies in some major industrial countries. Unless potential creditors are sure that an appropriate policy environment will be maintained and that new resources will be directed toward productive investment, a resumption of private creditor flows cannot be expected. However, I would add that it seems clear that the debt burden itself has also undermined debtors' efforts to successfully implement policy changes.

Private sector creditors must continue to act with flexibility and imagination in dealing with the debt problems of developing countries. In this regard, the market has responded with a degree of innovation in the development of the menu of financing options. My authorities support the continued development of market-based options, but would like to emphasize that such initiatives should arise from the debtor and bank participants themselves and that creditor participation in debt reduction programs should be on a voluntary basis.

Debt reduction schemes that allow debtors to take advantage of the prevailing market discounts on their debt, including debt buy-backs and debt-asset exchanges, have been the focus of increasing interest. In this connection, private creditors have a legitimate concern with regard to the sources of funds supporting the implementation of such schemes, and clauses in existing loan agreements can be an impediment. However, as pointed out in the background paper, banks have shown some flexibility with respect to the repayment provisions in their loan agreements, for example, by granting waivers in some cases to make such schemes operational.

There also has been market innovation in response to the increasingly evident divergence of interests among creditors, which in the extreme is represented by the free-rider problem.

In my authorities' view, one of the major challenges for the debt strategy will be to find means to cope more effectively with the free-rider problem.

The staff's survey of the regulatory responses in creditor countries to financial innovations was very useful. The regulatory environment has an important influence on the development of new financing techniques, and I would encourage Governments to keep regulations under review, so that the development of menu options is not unduly inhibited.

In general, my authorities agree that it is vital to establish a mix of debt management techniques so as to ensure needed external finance and domestic political support for the adjustment process. To this end, they welcome the various innovative developments in financing options, which have as their aim, inter alia, the reduction of the debt burden of the heavily indebted countries. These approaches open new avenues to the management of the debt strategy, promising, in some cases, to provide viable alternatives to debt restructuring. In this connection, I agree with Mr. Posthumus that the current approach, as a case-by-case strategy, is consistent with, and should incorporate, such innovations.

It is therefore of considerable importance that efforts be made to remove impediments to the market acceptance of various financing options. However, it must be emphasized that, while these options may help in coping with the problems of some debtor countries, neither debt-equity swaps, exit bonds, nor any similar market-oriented approaches can be regarded as a panacea that will bring the debt problem quickly to an end. In the longer run, there can be no substitute for continued adjustment efforts on the part of debtors and for adequate financing--through various modalities--by creditors.

As regards the Fund's role in the management of the debt situation, my authorities note that this question is currently the subject of an important study being carried out under the auspices of the Group of Ten. One aspect of the study will examine the catalytic role of the Fund and the World Bank. At this juncture, my authorities would again emphasize that the most important aspect of the Fund's role is helping members to develop and implement strong programs, and supporting such programs with its own resources. In addition, as this chair has indicated on earlier occasions, my authorities feel that it is useful for the Fund to consult with creditors, including banks, in the process of establishing the financing needs of the program. In addition, the Fund should stand ready, subject to the agreement of the member involved, to discuss the member's program with creditors. However, in general, my authorities would be reluctant to see the Fund play a more ambitious role than this. In this connection, they feel that the techniques used in commercial bank financing arrangements should originate primarily in the discussions between the banks and the members concerned. The Fund's contribution should probably be limited to research concerning the implications of ongoing innovations, and, when requested by the parties involved, providing advice and possibly technical assistance.

Finally, the staff suggests that financing assurances may need to be evaluated in more qualitative terms in the future. However, my authorities feel that it should still be possible to estimate financing needs and gaps, notwithstanding the use of various menu options, including debt reduction. They feel that obtaining reasonable financing assurances is critical, and that an easing of the latitude used in determining critical mass would not be appropriate at this time.

Mr. Goos made the following statement:

I broadly agree with the staff's analysis, which I found refreshingly brief and concise, and I will therefore offer only a few observations.

It might be true that progress toward financial viability has been slow so far in a number of indebted countries, and there are certainly worrisome signs of fatigue on the part of both debtors and creditors. But, putting things into perspective, the swift conclusion of the most recent bank financing package with Brazil, as well as the impressive number of ongoing Fund-supported adjustment programs, do not suggest that the problem of fatigue has become a universal phenomenon. Moreover, one must not lose sight of the magnitude of the initial distortions at the onset of the debt crisis and the clear unsustainability of the preceding savings and consumption patterns, which no one expected to be corrected overnight and certainly not without costs for consumption, investment, and growth. Six years of adjustment should, of course, have provided an opportunity for substantial progress. But only a few countries were able to pursue a persistent course of adjustment over the period, while many have shown a stop-go performance--a pattern that has continued, as evidenced, for example, by the strong revival of inflation and the recent widening of fiscal deficits in a number of countries. Moreover, the necessary reorientation of the initially predominant demand compression toward a more comprehensive strategy of financial stabilization and structural reform has taken place in virtually all cases only in the more recent past.

Against the background of such policy shortcomings, the performance of the heavily indebted countries since 1982, as shown in Appendix Table 5, although certainly less than satisfactory, is not too bad, particularly in regard to growth, considering that in 1984 and 1987 there were only 5 instances of negative rates of growth out of a total of 20 countries. Debt to GDP ratios, to be sure, have substantially deteriorated, as noted by Mr. Ortiz in particular, although I am reluctant to share his conclusions. First, unless it is assumed that the increase in the ratios is merely a result of valuation changes, these ratios reveal that the countries in question had substantial access to external resources; and second, the increase in the ratios is not necessarily a matter for concern if the resources received have been used for productive investment that eventually should help the country to outgrow its debt burden.

For these reasons, I would conclude with the staff and others that there is little that would invalidate the existing debt strategy, including its underlying case-by-case and market-oriented approach. And I would agree with Mr. Posthumus and Mr. Massé that it provides the flexibility necessary to include, where appropriate, debt reduction. Consistent with the evolving character of the strategy, all of the parties involved are, of course, expected to improve their contributions wherever possible. This applies certainly to debtor countries whose policies, I agree, remain at the heart of the debt strategy. There is certainly also scope for improving the modalities of financing flows as discussed in Sections 2 and 3 of the staff paper. In that regard, I only have a few comments.

First, with regard to the poorest countries and official financial assistance, my authorities share the concerns expressed by Mr. Posthumus about introducing the menu approach into official debt restructuring. But I should recall in this context the substantial amount of debt relief my country has already provided to the poorest countries, and I understand that my authorities have declared their intention to increase this amount in cooperation with multilateral development banks.

A second point relates to the staff's recommendation to employ debt reduction techniques in a gradual manner over time so as to maintain the discounts in the secondary market. To the extent that the creditworthiness of debtors is reflected in the size of such discounts, I would have thought it more appropriate--indeed, consistent with the ultimate objective of the debt strategy--to work as expeditiously as possible toward the elimination of market discounts. I certainly would not support a strategy of deliberately delaying full restoration of creditworthiness in order to maximize debt concessions to be extracted from creditors. Did the staff have in mind a phasing of debt reduction in parallel with progress on adjustment as discussed in the last staff report on the debt strategy? The staff's comment on this point would be helpful.

The third point relates to the matter of externalities of individual bank decisions, which has been discussed by Mr. Finaish. While I sympathize with the concerns expressed in this regard, my authorities feel that the more active regulatory approach advocated by Mr. Finaish--which certainly would have to be coordinated on an international level--would be neither desirable nor feasible. This, of course, does not mean that regulatory and tax authorities should be insensitive to the potential repercussions of their actions which, as acknowledged by Mr. Finaish, is obviously not the case.

A more promising approach to the resolution of those and related problems is offered by the advisory role of the Fund as outlined in Section 4 of the staff paper and as elaborated upon by Mr. Finaish. However, I should add that I share Mr. Posthumus's concerns about too close an involvement of the Fund in the design of medium-term financing plans of the kind under discussion. In addition to the reasons mentioned by Mr. Posthumus, I wonder whether in the process, the Fund might not be perceived by the banks as taking sides with the debtor countries, which could affect the cooperative nature of the debt strategy. Moreover, too close an involvement of the Fund could give rise to undue expectations or demands with regard to the Fund's own financial contribution, and thereby jeopardize its catalytic role.

Finally, on the matter of the critical mass, I strongly feel that for well-known reasons, the Fund has to maintain the existing policy on financing assurances, and I therefore would see little justification for another review of that policy. I recognize, of course, the valuation problem that arises in the context of debt reduction and similar techniques, but I would assume that the banks themselves will have to develop valuation criteria in order to ascertain the comparability of individual contributions within financing packages. I therefore wonder whether it would not be possible for the Fund to develop either its own quantified criteria or an appropriate survey system for the collection of the necessary information from the banks. I would be grateful for the staff's comments on this point.

Mr. Kafka, noting Mr. Goos's comment that the rapid conclusion of Brazil's debt negotiations with the banks was one example of their continued willingness to render assistance, observed that his Brazilian authorities did not feel that the negotiations were particularly rapid. Above all, they were sure that without the consistent and strong support not only of the Fund but of several Governments of creditor banks, the negotiations would have taken even longer.

Mr. Goos said that he fully agreed with Mr. Kafka that the Fund's involvement had played an important role in Brazil's negotiations with the banks. That was in conformity with the experience with such negotiations since the outbreak of the debt crisis. He wondered, however, whether the process would not have been accelerated if Brazil had approached the Fund earlier.

Mr. Ortiz recalled that Mr. Goos considered that the increase in debt/GDP ratios was a sign that credit flows to indebted countries had continued. But that was not at all the case. The worsening of debt/GDP ratios largely reflected currency depreciation. The point was an important one, because to the extent that debt/GDP ratios had deteriorated owing to exchange rate movements, there had been a real increase in the debt burden, as more national product was required to service the existing level of debt. As for Mr. Goos's comment on the Fund's involvement in preparing medium-term financing plans and the banks' perceptions that in doing so, the Fund might be taking sides in the debt strategy, he considered that by assisting its members the Fund would help to balance the scales in debtor-creditor negotiations; in any event, he had always thought that the Fund was on the side of its membership.

Mr. Goos replied that he had explicitly acknowledged that valuation changes underlay the change in the GDP/debt ratios. But exchange rate changes were not the only explanatory factor. Financial flows to the indebted countries were another factor. Furthermore, in expressing concern about the Fund's role vis-à-vis developing countries, his comments were inspired by the staff's recommendation that countries should aggressively exploit any market discounts in order to maximize debt relief. Depending on how that was done, it might give rise to concerns on the part of the banks and to the perception that the Fund was one-sidedly pursuing the cause of the developing countries. His understanding was that the Fund should take a more neutral position with respect to relations between the membership and the banks.

The Chairman remarked that in keeping with the concept of positive neutralism, the Fund should act as an honest broker and should stand ready to help all parties to find positive, imaginative solutions to the debt problem without being seen as favoring one side or the other. That would be in the interest of the entire membership.

Mr. Posthumus observed that in Yugoslavia's negotiations with the banks, agreement had been reached more quickly than with official creditors. That experience provided a further illustration of the banks' continued participation in the debt strategy.

Mr. Cassell made the following statement:

> The question posed by the staff paper is essentially: how can the Fund kindle the light at the end of the tunnel? Although the paper may not provide the whole answer to that question, it certainly provides a great deal that we ought to think hard about. The paper's emphasis on the continued importance of the case-by-case approach and appropriate economic

policies in debtor countries is clearly correct. So also is its warning of the dangers inherent in a vicious circle of debtor and creditor fatigue. Finding more effective ways of catalyzing bank financing of debtor countries, at a time when the banks themselves see new opportunities for lending opening up nearer home, will entail considerable innovativeness and possibly some urgency. Yet, for the next few months, such a sense of urgency may be difficult to impart.

I am less distressed than the staff seems to be at the thought that some developing countries might have to run current account surpluses for several years. This might be an inevitable stage in the process of adjustment. I am more concerned, like Mr. Ortiz, about how this adjustment has been brought about. But here, it must also be acknowledged that not all reductions in investment are to be deplored. There are investment projects in developing countries that cannot by any test earn an economic rate of return. My worry is that such investments often have a considerable power of survival, with the result that investments better attuned to the economic needs of the country are squeezed out.

Another cause for concern is the substantial down-side risk to the projections of the external environment of debtor countries. The latest worldwide increases in interest rates are, of course, a warning of this risk. There must also be some doubt about the staff's view that commodity prices may now have adjusted fully. In short, the background against which the paper is constructed could be overly optimistic.

All this does not lead me to dissent from the staff's main conclusions, in particular, that an imaginative menu is needed that will permit, in appropriate cases, negotiated debt reduction to be a significant part of the strategy for growing out of debt. There is nothing very startling in this; it is only part of an evolutionary approach. I endorse Mr. Posthumus's view of the debt strategy as "a case-by-case, market-based strategy that can, and where appropriate, should, include debt reduction."

If debt reduction mechanisms are to contribute significantly to improving growth prospects and reducing future debt service obligations, they will need to go beyond the exit mechanisms so far included in concerted lending packages. Possible alternatives might include, for example, debt buy-back arrangements or asset exchanges such as those recently carried out by Bolivia and Mexico. It is important, therefore, to identify and, where possible, to remove impediments to the development of such new instruments, along the lines suggested by the staff--for example, including general waivers in renegotiation agreements to allow a wide range of debt reduction mechanisms to be introduced at the appropriate time. Changes in taxation and regulatory arrangements in some creditor countries could also be helpful in this context. But the specific suggestion that tax relief should be given only on forgiven debt could discourage provisioning and so run counter to regulatory policy in most creditor countries.

The Fund has an important role to play in managing the debt strategy. So also have other international financial institutions, not least the World Bank--whose credit enhancement powers, if used selectively, could assist in calling forth more bank financing. In view of the seriousness of the debt problem, the Fund needs to look carefully, and with an open mind, at every possible measure for easing it.

Mr. Al-Assaf made the following statement:

Looking at developments in the debt situation since the inception of the crisis in 1982, it is comforting to note the success of the cooperative approach in largely reducing the systemic threat. At this stage, the Fund has graduated from crisis management to ensuring that both creditors and debtors persevere in their efforts to tackle the debt issue. Nonetheless, there is no room for complacency as we now face a combination of lending and adjustment fatigue.

An important development in the debt strategy has been the distinction drawn between low- and middle-income countries. For the first group, market-based solutions seem impractical at this stage, and thus official creditors have a major role to play. Indeed, official creditors have recognized this role and have, on an individual basis, approved comprehensive debt consolidation along with longer grace and repayment periods. However, the well-being of these economies remains largely dependent on the adoption of appropriate domestic policies. The Fund, through its enhanced structural adjustment facility, is now better equipped to assist in formulating and implementing the necessary measures in a medium-term framework. What remains crucial is an unwavering commitment by the authorities concerned to such an adjustment effort.

The problems of the middle-income countries pose a different challenge, as three facets of the debt problem clearly emerge: the size of the debt and ways to reduce it as a share of GDP; the ability to obtain new resources; and debt service as a share of export revenues. It is ironic that the positive aspects of the current strategy have led to lender fatigue and have encouraged banks' individual interests to resurface. At the same time, and sometimes in spite of significant adjustment efforts, debtor countries have made increasing use of arrears as a financing technique. This practice not only contributes to a deteriorating financial environment, but, more important, it induces policy slippages and a stop-go approach to adjustment. The stop-go approach exacerbates the debt overhang problem by discouraging the provision of new money, and reduces debt-servicing capacity by disrupting gains in the external sector.

The emergence of the market-based menu approach is clearly a welcome development that should be built upon. Further innovations in this area will provide both creditors and debtors with a wide array of options that best suits their individual circumstances. This is especially important in light of the reduced cohesion of creditor banks. The menu approach provides an opportunity to reduce the total volume of debt by having the banks share part of the burden. It also enhances the commitment of debtors to service and repay their obligations. A consistent and clear regulatory environment in creditor countries will contribute to the success of this approach. The array of menu options and the range of circumstances of indebted countries provide further strength to the case-by-case strategy, which I fully support. Nonetheless, the limitations of the market-based menu approach need to be recognized, as it can only partially address the debt burden.

It is evident that the only satisfactory way out of the debt problem remains through economic growth, structural reform, and export expansion. For most indebted countries, this will require a significant and healthy development of private sector activities and a corresponding reduction in the role of government. This strategy is only viable if export outlets are accessible to the adjusting countries, which, in turn, implies that, for many industrial countries, the best contribution toward a solution to the debt problem could be a further opening of their domestic markets.

The Fund has a role to play in this process. The Board's forthcoming discussion on trade and industrial policies of developed countries should enable us to make a first step in this direction. The Fund has also enhanced its ability to assist debtors through its revitalization of the extended Fund facility. Nonetheless, the catalytic role of the Fund is best reinforced through its insistence on strong and comprehensive adjustment programs. In this context, I, too, share Mr. Posthumus's hesitation regarding a possible Fund role in devising medium-term financing plans that optimize market opportunities.

In sum, the debt strategy has gone a long way to remove the systemic threat resulting from the debt crisis. The task, however, is far from complete, and much remains to be done. While I welcome the recent developments in the market-based menu approach and strongly encourage further innovation in this regard, the menu approach can only be viewed as a compliment to, and not a substitute for, our overall approach. The basic tenets of the strategy remain structural adjustment, economic growth, and free trade.

Mr. Sliper made the following statement:

My authorities generally agree with the staff's analysis. It is accepted that the staff papers do not report on any major new developments in the debt management strategy nor do they propose any radical departures from the existing approach. Although progress remains slow in restoring growth in many of the middle-income, highly indebted countries, my authorities see no viable alternative to the present case-by-case, market-oriented approach. They also support the application of further voluntary, market-oriented techniques to broaden the menu approach and enhance the flexibility of the present strategy.

It follows then that my authorities are basically opposed to global debt forgiveness proposals that transfer risk from the private sector to the international institutions or creditor governments. In this regard, I support the proposal put forward by Mr. Posthumus that in its report to the Interim Committee, the Executive Board should endorse the present approach, including debt reduction proposals where appropriate, and thus help focus the discussion on issues where some progress is possible.

My authorities agree with most of the basic propositions set out in the staff paper. They agree that policies in debtor countries remain at the heart of the debt strategy. However, they would note that policy adjustments in industrial countries, including the trade area, are also vitally important, and this point could have been usefully expanded in the staff paper. They also agree that effective growth policies require adequate financing; that debt management techniques, including, where appropriate, debt reduction techniques, need to be blended with new financing to achieve optimal external financing and domestic support for the adjustment process; and that the Fund has a vital interest in seeing effective restructuring of international assets and liabilities through the menu approach to help reduce reliance on sustained use of Fund resources. It is accepted that the Fund should consider new ways of assisting debtors to rationalize their balance sheets, such as in the case of Bolivia, provided they do not interfere with normal debtor-creditor relations.

My authorities have some reservations, however, about the idea that a key function of official sources of longer-term financing is to bridge the period when market perceptions lag the adjustment effort. This appears to suggest more than a catalytic role for Fund and World Bank financing of debtor countries' programs in circumstances where banks may correctly perceive the degree of sustained adjustment effort but seek to reduce their exposure and shift burdens to the official sector for basically balance sheet reasons.

The staff paper refers to a consensus in respect of debt forgiveness proposals for the poorest countries. I note that this consensus refers only to the Group of Seven nations that attended the Toronto summit. Moreover, as the discussion has shown this morning, this consensus is perhaps not as firm as originally thought. In respect of the Toronto Summit declaration, my Australian authorities are concerned about the option of applying interest rate concessions on trade-related claims. Their concerns relate mainly to the introduction of aid criteria into Paris Club rescheduling of commercial trade-related debt. They also warn of the risks of raising expectations that concessions on trade-related debt should be extended to countries other than the poorest distressed nations of sub-Saharan Africa.

As regards the role of the Fund, my authorities have some reservations about the staff's suggestion that on occasion, financing assurances should be evaluated in more qualitative terms particularly with respect to determining critical mass in those cases where debt reduction is blended with new money. They consider it important that the Fund adheres to the financing assurances required for approval of Fund-supported programs. A less than rigorous application of the Fund's policy on financing assurances increases the risk of overdue obligations to the Fund and has, in the past, been a contributing factor to the failure of a number of programs. While changes in the blend of financial packages--debt reduction versus new money--may blur the traditional meaning of the "critical mass" of participating banks in the context of commercial bank financing packages, they should not lead to the approval of Fund-supported programs where financing gaps have not been fully closed.

Mr. Zecchini made the following statement:

The latest data on the debt situation of developing countries confirm the validity of the two different propositions put forward by creditor countries and debtor countries, respectively. The one proposition asserts that since the onset of the debt crisis, substantial progress has been made in easing the debt difficulties of all developing countries. The other proposition argues that progress has not been sufficient to overcome the debt difficulties and that there is far to go before normal financial relations can be restored for a large number of indebted countries.

A few recent developments bear witness to both propositions. Important financial packages have recently been finalized for some of the major debtors. After a decline in 1985-86, net bank lending to indebted countries has rebounded in 1987-88, while the terms of financing have improved significantly for the debtors, leading to an increasing degree of debt relief. Furthermore, the financing options of indebted countries have multiplied, thereby providing additional flexibility in matching the asset preferences of both debtors and creditors with the liability preferences of debtors. Last but not least, the process of adjustment of external imbalances and economic reform has continued to develop without significant reversals.

In spite of these favorable developments, several major causes for concern persist. First, the ratio of external debt to both GDP and exports of goods and services remains relatively high. As a result, the claim of external debt on domestic resources is still substantial in spite of the recent reduction of interest costs. According to the latest report on the world economic outlook, the debt service ratio for the group of capital-importing countries is expected to decline in 1988 but to a level that is still higher than that at the beginning of the 1980s.

The second major cause for concern is the fact that the recent expansion of net bank lending to the group of indebted developing countries is concentrated on a few countries which are still dependent on concerted lending packages. In general, banks continue to resist generalized increases in exposure, and in particular, general purpose lending. This resistance entails two worrisome consequences. First, discrimination in bank lending among developing countries is not receding nor is it based on a better evaluation of the debtor's present and prospective capacity to repay. It is apparent that several banks are trying to scale down or discontinue their international lending in some geographical areas, and, consequently, lending risks tend to be more concentrated in a few institutions. Second, although the increasing opportunities for project financing are beneficial to the extent that they guarantee the appropriate use of foreign savings, they do not diminish or eliminate the need for balance of payments financing. The latter is necessary not only for the more efficient management of the business cycle but also to ensure a smooth servicing of the large stock of accumulated debt. Therefore, under present circumstances, an increase in project lending cannot be considered as a substitute for general financing, except to a very limited extent.

Another cause for concern is the recent increased use of arrears as a means for financing. This development calls directly into question whether this institution and the monetary authorities of the creditor countries have adequately fulfilled their responsibility to prevent factors of instability in the international financial system and preserve the soundness of the system. The debt strategy followed so far is not ill-conceived. In fact, it tries to address the specific debt problems of individual countries in the framework of extensive improvements in the economic policies of the debtor for the purpose of restoring the sustained and balanced growth of its economy.

However, this strategy is indeterminate insofar as its financial component is concerned, while its ultimate success depends on the unpredictable convergence of the interests of nonofficial lenders with those of multilateral institutions, like the Fund, and of monetary authorities in major creditor countries. This convergence is far from certain in the present strategy because it is, in turn, a function of the changing perceptions of these nonofficial lenders with respect to the costs and benefits of cooperating in the strategy. Such a convergence of interests was widespread in the early stages of the debt problem, but it is now shrinking dramatically as an increasing number of lenders do not find it convenient from the point of view of their balance sheets and their profit and loss accounts to commit themselves to the development of this strategy. Hence, there are grounds to doubt whether a purely market-based approach to the financial component of the strategy is adequate to allow countries to grow out of their debt in the medium term.

To fill the gaps in this strategy, consideration should be given to the possibility of extending the range of options in the menu approach so as to create appropriate incentives for nonofficial creditors to remain active participants in the debt strategy. The strategy has to take into account two most recent developments that have a different impact on the debt burden of developing countries. The first is the steep rise of commodity prices in the period 1987-88, which has improved the terms of trade of many indebted countries, thereby enhancing their debt-servicing capacity. The second is the current trend toward higher interest rates in financial markets, which tends to increase the debt service burden directly and to reduce the debt-servicing capacity of these countries indirectly, to the extent that monetary tightening in the industrial countries slows down the growth of the major export markets of developing countries. Although it is not possible at this stage to quantify the net impact of these two factors, it is most likely that the net result will be contrary to an easing of the debt problem.

In the light of these developments, debtor countries and the Fund should stress the need to assign priority to the objective of lowering debt/export ratios in the present debt strategy. Any debt relief that a debtor might gain should not leave open the possibility of assuming new liabilities at this juncture of the world economy. Efforts should instead be directed toward achieving lower, sustainable debt/export ratios and adjusting the rate of domestic absorption accordingly. Excepting this aspect, the thrust of the present debt strategy based on strong adjustment to achieve a durable growth in the medium term still seems valid.

The specification of this approach has to be tailored to the characteristics of the debtor. In this respect, the means to ease the debt difficulties of the poorest debtors is not at issue: they are not market borrowers and their official creditors have already given proof of extreme flexibility in rescheduling debt on concessional terms and in providing debt relief. More controversial is the approach to the debt of the other developing countries, which form a rather small group characterized mostly by an intermediate level of per capita income. Even in this small group, economic and financial conditions vary to such an extent that they do not allow generalizations regarding the use of instruments to mitigate their debt difficulties. A common feature of these debtors is their reliance on market sources of financing. Consequently, nonofficial creditors have an essential role to play in the negotiation of a solution to the debt problem of these countries.

The staff appropriately distinguishes three categories within this group based on the size of the financing need, the capacity to repay, and the attitudes of the lenders. I agree with the staff that a viable approach to the debt problem lies in an appropriate mix of different debt management techniques, which need to be broadened and deepened. Although it is difficult to specify in abstract what the optimal financing mix should be for each of the above-mentioned categories of debtors, some examples for the third category should also have been provided in the staff paper.

The impediments to the market's acceptance of a concerted approach to restoring a balanced relationship between the stock of debt and the debtor's ability to service its debt over the medium term are still significant and even go beyond those described by the staff. Wavering adjustment efforts on the part of the debtors and insufficient prospects for an adequate risk-adjusted profitability of new lending in some geographical areas should be included in the list of impediments. It must also be recognized that differences across creditor countries with respect to their regulatory, accounting, and tax provisions actually restrict the range of financing options, which might otherwise appear to be broad enough.

A clear conclusion that should be drawn from this debate is that significant improvements are still necessary to make the current debt therapy effective and faster-acting. A continuation of the current slow pace of improvement will increase the risk of fatigue for both creditors and debtors, and, consequently, the risk of continuing vulnerability of the international financial system. Improvements in the present strategy should be sought particularly in four areas: the spectrum of financing options; the incorporation of a debt relief element; the harmonization of regulatory provisions; and the free-rider problem. As to financing options, attention should be focused on debt reduction techniques. With regard to debt relief, the paper by Mr. Corden, "Is Debt Relief in the Interests of the Creditors" (WP/88/72, 8/8/88; and Cor. 1, 8/17/88), clearly demonstrates the interest creditors should have in some forms of debt alleviation. Increasingly, there appears to be a trade-off between the provision of new money in concerted lending and interest remission, or deferment, on outstanding debt as well as between the certainty of the repayment of the principal with a below-market interest rate and the recording of a capital loss with a market rate on the residual assets. With respect to regulatory differences among countries, efforts should be deployed to harmonize present regulations and possibly to refine the recent agreement of the Group of Ten on capital adequacy. Financial innovations might also help solve the free-rider problem.

The Fund has already contributed to the implementation of the debt strategy by enhancing its financial facilities. In addition, the Fund should stand ready to support creditors and debtors in their efforts to find new solutions to the debt problem, without raising its lending risks. The establishment of trust accounts, such as that for Bolivia, or an advisory role in putting new financing options in place are areas in which the Fund should be involved. Such activities would complement and enhance the Fund's traditional role of assisting countries in designing and monitoring adjustment programs as well as providing its financial support and catalyzing external financing.

Mr. Ovi made the following statement:

I am in broad agreement with the analysis contained in the staff report. I shall concentrate my remarks on the situation of the middle-income countries and comment only briefly on the low-income countries.

The basic concept of the present debt strategy--namely, a cooperative approach to enable debtor countries to grow out of debt--remains valid. Also, there is no substitute for a market-based approach. Calls for generalized solutions in the form of international debt facilities relying basically on the availability of financing from official sources will only delay the final resolution of the debt problem.

Within this overall framework, it is important to recognize not only that evolution takes time, but also that actual developments over the past few years have followed an entirely logical--and increasingly realistic--trend. This is not to say that the process is, and will be, a smooth one. A characteristic of developments in the past year has been the growing reluctance of commercial banks to increase their exposure vis-à-vis indebted countries. At the same time, debtor countries have increasingly used the accumulation of arrears as a major source of ex post financing. These tendencies are extremely worrisome: they endanger the cooperative approach and could potentially have major damaging effects.

Recent experience leads the staff to suggest that the era of concerted, new lending from banks is past. While I basically agree with the staff as far as the smaller debtor countries are concerned, it seems to me that the recent experience of Yugoslavia and Brazil does not validate this view. Rather, it has been surprising to see how quickly banks have responded to financial packages for those two countries. The end result was a further increase in banks' exposure. With respect to the large debtor countries, however, I agree with staff that when drawing up medium-term scenarios, one should be careful not to assume an automatic growth in the exposure of banks.

Although the increasing concentration of outstanding lending on a smaller number of large international banks could potentially make the provision of additional lending more difficult in certain cases, it is both a logical and welcome development. In this regard, I note a change in the staff's view on the free-rider problem: it seems to acknowledge that notwithstanding a possible authoritative interpretation of Article VIII, Section 2(b) by the Board, such a ruling would likely be challenged by courts in a number of countries. If this is correctly understood, the Board should not devote any more time to this legal issue. Any solution to the free-rider problem will instead have to be based on making exit bonds sufficiently attractive or finding other similar arrangements, such as debt buy-backs.

The banks' withdrawal from medium- and long-term balance of payments financing has clearly made sustained adjustment by countries even more difficult. Therefore, to protect their own exposure, banks ought to adopt a more flexible approach. Debt relief and debt reduction could be fully consistent with a market-based strategy. Like Mr. Zecchini, I found convincing arguments to this effect in the recent paper by Mr. Corden. Moreover, I agree with the staff on the need for a further development of tax and supervisory rules in some creditor countries aimed at both stimulating the evolution of new financial instruments and attaining higher predictability in the working of such rules.

Although I agree in principle with the staff that debt reduction together with, or as a substitute for, new lending might be necessary, and that this in combination with credible adjustment might enhance the creditworthiness of a country, I wish to caution against exaggerated expectations regarding the potential importance of debt reduction. Often, there will remain a trade-off between the demand for new money and debt reduction. Also, although one should be careful in postulating that market reactions might be "wrong," clearly changes in market prices in the secondary market reflect a number of factors, including changes in the regulatory framework.

It is hardly realistic to expect that additional long-term financing from official sources will become available for the middle-income debtor countries. Also, I am somewhat skeptical about the staff's suggestion that in the period ahead, a key function of official sources of longer-term financing remains to bridge the period when market perceptions lag the adjustment effort. The ultimate purveyor of funds should be the market, and official policies must avoid giving signals that would distort the future allocation of resources and undermine the ultimate responsibility of debtor and creditors. In view of market perceptions, financing gaps must be covered through adjustment programs, supported if necessary, by arrangements with the Fund.

The role of the Fund has been intensively discussed by the Board in recent months. The Fund's role in providing financial support in connection with adjustment programs in highly indebted countries has already been enhanced following the revitalization of existing Fund facilities and the establishment of new ones.

The possibilities for the Fund to contribute to members' efforts to enter into voluntary and effective rescheduling agreements rest on the assumption that to have the desired effect, the agreements will have to be founded on strong underlying economic programs. The possible introduction of contingency mechanisms in Fund-supported programs means no change in this regard. At this stage, I share the concern expressed by a number of Directors, particularly Mr. Massé, Mr. Goos, and Mr. Prader, as to the degree of ambition the Fund should have in trying to develop debt reduction packages.

The staff has suggested that financing assurances on occasion may have to be evaluated in more qualitative terms. Further, it has indicated that the questions that arise for the Fund in this context would need to be considered over the coming months. I hope that the staff can assure me that it does not foresee any deviation from the requirement of full financing of a program but rather that one particular trigger mechanism would have to be replaced by a higher degree of judgment. Also, I should like to hear the staff's view on how the catalytic role of the Fund could be enhanced within the framework of existing principles for financing assurances.

With regard to low-income debtor countries, important initiatives have been taken over the last year, most recently at the Toronto summit. However, these arrangements still have to become fully operational. I agree with the staff's comments on the need for improved coordination of efforts in relation to low-income countries but wonder what the staff has in mind when it suggests that other mechanisms--in addition to the policy framework paper--might be required.

Mr. Salehkhou made the following statement:

While I commend the staff papers, which provide a concise yet comprehensive analysis of the debt situation, I feel that the analysis does not go far enough. The solutions envisaged would only offer some temporary relief in the short and, at best, medium term. No sustainable or lasting solution would be realized even with the most optimistic assumptions underlying the staff's analysis and proposed options. Accordingly, rather than comment on issues presented in the paper--for almost all of which I have taken positions on earlier occasions--I will concentrate my remarks on two proposals to which I have previously referred, namely, the creation of international mutual funds and a convention on capital flight.

In managing a crisis, temptation usually exists in, and experts become obsessed with, looking for new and imaginative approaches. This at times causes one to overlook the traditional approaches to solving the problem that could often best provide an effective and lasting solution. Such may have been the case in handling the debt situation, and it is my intention to propose today one such approach, which is neither original nor new.

Over the past five years we have observed many attempts to solve the ever-growing debt problem. Although many case-by-case strategies have been offered, the few cases attempted have been those with the greatest likelihood for preserving the status quo. Judging by the variety of unsustainable strategies offered mostly by creditors, doubts are created as to whether an effective and lasting resolution of the problem is in sight or of real interest to major creditors. If we are unable to resolve the present debt situation, at the very least thought should be given to ways to avoid the eruption of similar crises.

Perhaps the present debt impasse could be summed up in the following way. The question of debt servicing has resulted in debtors resorting to arrears as the only source of new financing. At the same time, creditors are reluctant to increase their exposure in debtor countries in view of their debt-servicing difficulties and the existence of capital flight. Gloomy prospects for debtor economies owing to the lack of financing for economic growth, in turn leads to further pessimism. This is as close as one can get to a vicious circle: the debt problems lead to growth problems that further aggravate the debt problems.

In this light, and in line with remarks I made in this Board some time ago, I would like to offer a way not only to break out of this vicious circle but also to convert it into a virtuous circle. It was in the same spirit that I earlier proposed the establishment of international mutual funds through which private and public funds to developing countries can be channeled by means of the purchasing of equity shares.

The staff has expressed the hope that, at best, the "creditor-debtor" relationship could be changed to one of "lender and borrower." This would, at best, mean preservation of the status quo. The arrangement that I am proposing instead aims at changing the basic relationship into a partnership in development of the global economy in accordance with the charter of this institution.

I will not attempt today to enumerate all the advantages that can be envisaged by following this approach. A few positive features should suffice to illustrate the point.

In nearly all of the Fund's publications, the staff has invariably complained about the shallowness of capital markets in the developing countries. In contrast, the capital markets of the advanced countries are becoming increasingly more integrated in a United States-Japan-Western Europe triangle of financial centers in which new financial products and instruments are developing on almost a daily basis. As this triangle becomes fortified, there is a clear and present danger that the developing countries will be frozen out of the international capital markets even further than they have been in recent years.

The establishment of international mutual funds will guarantee the access of developing countries to the international capital markets. These countries will be able not only to avoid future debt overhangs but also to use these mutual funds to expand their domestic capital markets, thus mobilizing their domestic financial resources through transactions in mutual funds equity shares. The private sector as well as market forces will be strengthened through the provision of much-needed liquidity for viable but illiquid firms.

Lenders stand to gain because equity shares will provide them with built-in protection against capital value losses owing to inflation. It is well known that there is a long-run tendency for the general price level--and exchange rates--to move equiproportionally with the value of firms' real assets and output. Moreover, international mutual funds will be able to reduce the risks to investors by providing them with opportunities for portfolio diversification on the one hand, and inexpensive means of risk analysis on the other.

The world community, too, stands to gain through more efficient, market-oriented allocation of financial resources, and, since the value of investments will be tied to the performance of the private sector, the possibility of future debt crises will be avoided. Through these international mutual funds at least funding for future growth requirements will become available, and in this way, perhaps the vicious circle referred to earlier would be broken.

There are many more advantages to be gained by the establishment of such international mutual funds, but, for the sake of brevity, will not list them all here. Therefore, I would, like to propose again that the Research Department undertake to study the feasibility of the establishment of such mutual funds. I am confident that the result of such a study will show that these mutual funds will be pareto-improving devices for the world financial community.

As for the second proposal--the establishment of a convention on capital flight--I need not elaborate my views, which were expressed most recently during our recent discussion on the legal effects of approval or nonapproval of exchange restrictions by the Fund. The staff has rightly observed that the "return of capital flight" is a precondition for the "restoration of confidence on the part of both foreign and domestic savers." Furthermore, Mr. Ortiz has eloquently remarked that "the sword of Damocles of capital flight is perennially threatening to disrupt debtors' stabilization efforts while at the same time it serves as a convenient target for creditors' finger pointing at 'insufficient adjustment efforts' as an additional reason for withholding credit." Whether the issue is indeed used as a pretext for lack of provision of new financing may be debatable. What is certain is that capital flight is a real problem which concerns not only the economies of developing countries, especially debtors, but also those of the industrial nations by way of "activities related to underground economies, during trafficking, tax evasion, and laundering other illicit proceeds encouraged by bank secrecy laws and other protective devices offered by major capital centers and offshore entities."

In an earlier document (EBS/88/13, 1/28/88), the staff had concluded that in accordance with the Articles of Agreement, "exchange contracts could be regarded as void instead of simply unenforceable, or criminal sanctions could be applied in addition to civil sanction, in the case of breach of such regulations." On the basis of this and other provisions in the Articles, I considered that application of such civil and criminal sanctions would to a long way in alleviating the crime of capital flight and insisted that resolution of the capital flight issue should be regarded as an indispensable part of a viable, practical, and lasting solution to the debt problem.

Let me conclude by stating that I firmly believe, first, that the proposed convention is fully compatible with the provisions of the Articles of Agreement and, in view of the Fund's central role in the debt situation, is certainly within the competence of the Fund as a cooperative, international monetary institution; and second, that procedures similar to those applied in establishing the Multilateral Investment Guarantee Agency in our sister institution could be easily adopted for the establishment of the proposed convention on capital flight. I would urge the Legal Department to propose a draft for such convention which, together and in collaboration with the Research Department's study on international mutual funds, could present an indispensable solution to the debt problem. I would appreciate hearing the staff's views on the usefulness and practicability of the proposals I have put forward.

Mr. Fernando made the following statement:

Since our previous discussion of this topic, the actions of official creditors with respect to the debt of low-income, debt-distressed countries are the most noteworthy development in the debt situation. There is a recognition of the need for debt reduction, including--although not limited to--writing off some part of the debt. In view of the situation and prospects of many countries, particularly in Africa, the debt overhang is perceived as impairing their ability to grow out of debt. From the Fund's point of view, these latest initiatives should increase its credibility and strengthen its catalytic role, in that debt relief in parallel with its own initiatives--such as the enhanced structural adjustment facility--should improve the financing of adjustment policies while facilitating countries' attainment of an appropriate level of growth. In this context, the Fund should generate solutions to the problem of protecting the adjustment programs of countries eligible to use the structural adjustment and enhanced structural adjustment facilities from adverse exogenous shocks through mechanisms similar to those incorporated in the recently established compensatory and contingency financing facility.

The situation for other highly indebted countries is far from encouraging, as evidenced by the facts presented in the staff paper. The contribution of the menu approach is recognized; but its dividends are only a trickle and are balanced disproportionately in favor of creditors. Yet, adjustment requires a speedy effort, with an emphasis on structural measures, to make up for previous retrenchment. In this context, the many ideas focusing on the need for relief from the debt overhang are worthy of investigation.

Whatever mechanisms are adopted, the role of debt reduction in the debt strategy should be underlined. Mr. Posthumus has rightly said that further time should not be wasted in debating its pros and cons. Underscoring debt reduction in a case-by-case approach will also focus on members' regulatory, accounting, and tax provisions insofar as they impede the working of the debt strategy.

I note the staff's preference for market approaches, within which menu options are said to hold considerable promise. But in spite of the considerable shift in the current account positions of highly indebted countries over the last six years, debt burdens have continued to increase while growth rates have been unsatisfactory. This fact points to the need for a readiness to experiment with approaches that are not strictly market-related, if the intensity of the debt problem continues, or increases further. I welcome the staff's recognition that the effectiveness of market approaches will critically depend not only on the adjustment policies of debtor countries but also on the greater willingness of banks to negotiate debt-restructuring packages and maintain their exposure, as well as on the availability of reserves in the initial phase of debtor countries' adjustment effort in order to assure sufficient support for a steady pursuit of the desired adjustment path. The present situation clearly indicates that creditor banks have a more crucial role to play in countries' efforts to grow out of debt than is generally appreciated.

The staff paper correctly argues that in the future, the commercial creditor group could lose its "tail" of small or noninterested lenders and thereby reduce the incidence of delays in assembling financing packages. While this outcome is more beneficial for smaller debtor countries, it should be noted that these countries have experienced delays for reasons other than "reduced cohesion" among commercial banks. It is not clear how, in such situations, financing could be assured except by the accumulation of arrears. Also, the problem of delays is not confined to small debtor countries: in view of the banks' general reluctance to extend financing, delays could occur even in respect of larger debtor countries.

These comments should not be understood as favoring the accumulation of arrears as a financing technique; that approach would not ensure the operation of a judicious blend of policies and new financing. It is this blend that has to be sought within the case-by-case approach, but it cannot be prespecified as a universal formula. The key problem is determining a set of instruments for the country concerned. Such a determination is not easily reached without the support of the international community, especially with respect to the heavily indebted countries.

The staff sees promise in a menu of options from which instruments are chosen. In general, it favors mainly debt-equity and debt-asset exchanges, especially the latter. The staff suggests that a country's readiness to set aside national assets against new claims arising from reorganized debt would indicate the country's intention to service these debts and signal a step toward "re-establishing creditworthiness after a debt workout." But, I wonder whether the assets that have to be set aside would not, in practice, be in accordance with the banks' preferences. If so, political sensitivities could become prominent, which suggests a cautious approach with respect to expectations.

Finally, the role of official sources and the Fund in assembling financing packages often involves more than bringing the parties together, especially when the debtor country's adjustment policies are sound and are being implemented. Bridge financing together with additional commitments of resources by official sources would often help to improve market perceptions. A similar result could be achieved through a commitment of the Fund's own resources when it approves the policy program of a debtor country. The Fund may also need to judge the financing assurances obtained through debt reduction mechanisms in a qualitative way, rather than by strict quantitative rules regarding "critical mass." At times, the Fund's support would need to be maintained to encourage the timely cooperation of banks in assembling financing packages in respect of countries' implementation of the proposed adjustment policies. Such an approach would be particularly helpful for smaller debtor countries.

Mr. Santos made the following statement:

The present debt strategy, which has relied on a combination of economic restructuring in the debtor countries and adequate financing by creditors, has been only partially successful. The threat to the international financial system at the onset of the debt crisis has been averted, but the main aim of the strategy--to create the conditions for countries to grow out of debt and return to normal debtor-creditor relations--has not been attained.

Despite the strong and painful structural reforms undertaken by debtor countries, especially the low-income countries, the volume of capital inflows has been well below that required to ensure a satisfactory rate of economic growth. Even worse, under the present debt strategy, many of these countries have no prospect of growing out of debt in the near to medium term. Consequently, the accumulation of arrears has emerged as a financing technique.

In response to these developments, banks, in cooperation with debtors, have developed a menu of options to help finance countries' debt. Although the menu approach has helped to reduce temporarily the debt service burden of a few countries, it has not made it easier for countries to grow out of debt and to obtain the new money needed to implement effective growth policies. Moreover, the menu could be enhanced by the addition of further innovative instruments, if a major obstacle--namely, the regulatory, accounting, and tax provisions in creditor countries--could be overcome. I agree with the staff that greater consistency and more predictability on the part of regulatory agencies would help; but this alone will not be enough to solve the debt problem.

The case-by-case approach, combined with the menu of financing options, has certain advantages. However, the fact that similarities among different groups of debtor countries have led to their classification according to their debt profile indicates to a certain extent the need to integrate the case-by-case approach into a more general approach that addresses the common problems of the various categories of debtors. This fact has been recognized in recent proposals to reduce the debt of a group of low-income countries by converting part of their official debt into grants. While this development is welcome, further action needs to be taken to reduce the debt burden of these countries. Some recent proposals, particularly the proposal for creating an agency to purchase developing countries' debt and convert it into tradable securities as well as the proposal to make debt service payments equivalent to a proportion of export earnings, are worth pursuing, especially with respect to the middle-income indebted countries.

The three stylized scenarios presented by the staff highlight the crucial role that commercial banks are expected to play in the debt strategy and the importance of their willingness to resume normal relations with indebted countries. Since the banks' primary objective is to make a profit, they will continue to refrain from new lending so long as they perceive that the risks are greater than the benefits. This reluctance also indicates that commercial creditors have doubts about the adjustment programs being pursued by debtor countries, and about the ability of these countries to achieve the level of growth that is required to enable them to meet their debt obligations in the medium term.

The staff describes a menu of financing options that has the potential for reducing the debt burden while increasing debtor countries' access to new funds. This approach is interesting, but to be successful, it must be supported by the commercial banks, and such support is unlikely in the present circumstances.

As for the Fund, it should continue to develop ways and means to help mobilize resources in support of countries undertaking growth-oriented adjustment. The recent policy approaches adopted by the Board with regard to the extended Fund facility, the enhanced structural adjustment facility, and contingency mechanisms are steps in the right direction. But, if debtor countries are to achieve the objective of adjustment with growth, greater financial support from the Fund is required. This support could be in the form of greater access to financing and a lengthening of repayment schedules. In addition, a substantial increase in quotas and in SDR allocations should be considered. On another level, the Fund should encourage other parties in the debt strategy to commit themselves to a multiyear framework of financing in support of members' adjustment programs. Also, I agree with the staff's suggestion on the need to evaluate financing assurances on a qualitative basis in certain cases.

But, a lasting solution to the debt problem can be achieved only if the world economic environment is conducive to growth and financial stability. In that context, the Fund has an important role to play in ensuring that industrial countries follow economic and financial policies that keep their markets open, avoid wide fluctuations in interest and exchange rates, and encourage economic growth.

Mr. Dallara made the following statement:

In general, the treatment of the issues in the staff paper is balanced, although I have some reservations. I am not convinced, for example, that the discussion of stylized cases is particularly helpful, although I understand the utility of such analysis. Two categories as large and as heterogenous as the ones suggested here do not really point the way to pragmatic solutions in the context of the case-by-case debt strategy. There is also an excessive emphasis on debt reduction in general, and on specific techniques of debt reduction. At the same time, I recognize the potential importance of market-based debt reduction techniques, and I would certainly encourage debtors and creditors to find a way forward to explore and develop such techniques in individual cases. Furthermore, I see considerable risk for the Fund and other international financial institutions with respect to the "restructuring of assets and liabilities."

Instead of dwelling further on my reservations, however, I will offer some general thoughts about what the Board may wish to say collectively to members of the Interim Committee about the debt situation at their meetings next month. As I have indicated before, I believe that it would be a serious mistake to underestimate the progress that has been made during the past six years or to overestimate the potential benefits of alternative strategies, fatigue in some quarters notwithstanding. While I share the impatience felt by many creditors and debtors, I see no better course to follow than the strategy which has guided us for some years, and I remain firmly of the view that persistence will pay off--perhaps sooner than some analysts would consider likely.

Since the Board's last review of the debt situation, further progress has been made in five areas. First, the global economic environment continues to be generally favorable, despite concerns earlier this year that growth would falter. In this regard, I detected a different tone in the discussion of the outlook in the staff paper compared with that in the report on the world economic outlook. Could the staff explain why this report is more pessimistic concerning the near-term outlook?

Second, there is a general trend toward more effective implementation of comprehensive adjustment programs by debtor countries, in spite of setbacks and inconsistent efforts in a number of cases. We are also seeing the fruits of the policy framework process and the improved increase in collaboration between the Fund and the Bank with respect to the reform efforts of low-income countries.

Third, I continue to observe, and welcome, the further evolution and adaptation of the menu approach by commercial banks. I also welcome the efforts of the debtors themselves, which in some cases have taken more initiative than the banks in advancing the menu approach.

Fourth, at the Toronto summit in June, the leading Paris Club creditors announced their intention to increase the extent and attractiveness of debt relief provided to some of the low-income countries in Africa.

Fifth, the Fund itself has taken some important steps to increase its potential effectiveness in support of debtors' adjustment efforts, including the establishment of the contingency and compensatory financing facility, the revitalization of the extended Fund facility, and the activation of the enhanced structural adjustment facility.

Naturally, there remain areas of concern. Some of the largest debtors continue to encounter serious problems in correcting internal imbalances and reducing rigidities in their economies. There continue to be difficulties within the banking community in reaching agreement promptly on financing packages to support new adjustment programs, and in some cases, the delays have threatened to undermine or retard the adjustment efforts of the debtor countries. In particular, the banking community has been unable to move coherently and promptly to support the efforts of some of the small and medium-sized debtors. There continues to be pressure, primarily from the academic community, some elements of the banking community, and some members of the U.S. Congress to promote significant increases in official financing as a substitute for private financing--an approach which my authorities continue to believe is patently unrealistic.

In sum, the debt strategy is working. There continues to be a capacity within this strategy to incorporate change and flexibility as individual cases move forward, while adhering to the principles that have usefully guided us for some time. It will be important during the period ahead to continue to adhere to those principles, while remaining open to consider new techniques and new modalities to facilitate the handling of individual cases.

It is also clear that each of the participants in the debt strategy can do more. It is obvious, for example, that some debtor countries can intensify their own efforts to put into place and maintain sound domestic policies. They can also do more in some instances to take the initiative in developing workable menu items that can be marketed in the banking community. In certain areas, such as debt-equity conversions, the full potential of financing options has not been tapped, in part because of a reluctance in some countries to pursue these approaches actively. The staff is perhaps unduly pessimistic in speaking of a "debt-restructuring treadmill," although I recognize that some elements of such a pattern are present. But in fact, several countries appear to be close to regaining normal access to international capital markets, including, for instance, Chile, Uruguay, and Tunisia. And these cases should not be discounted, because there are reasons to believe that over the months and years ahead other debtors will also succeed in implementing adjustment programs to the point that a renewed sense of confidence will begin to pervade more clearly their relations with the financial community.

Commercial banks have shown some encouraging indications of their willingness to work more actively with debtors in shaping financing menus that are tailored to the realities of individual countries. Perhaps the most impressive example in this regard is Brazil, where the collaborative efforts of the authorities and creditor banks appear to have produced an attractive and marketable package of menu items.

I mentioned earlier the need for the banks to intensify their efforts and to give greater priority to the problems of small and middle-sized debtors. This important concern of my authorities is taken into account in discussions with our own banking community. They see little scope, however, for changes in the regulatory and tax areas, or for a larger financing role for official institutions.

The staff paper suggests that the ability of banks in some countries to establish large tax losses may work against the evolution of the menu approach. This point is interesting, but I am not sure that I fully understand it; further elaboration by the staff would be helpful.

I have already mentioned the areas where the role of the Fund has been strengthened over the past months. It is clear that debtors and creditors will continue to rely on the Fund to play a central role in pointing the way to solutions for individual countries, both by providing advice on the appropriate mix of domestic policies, and by catalyzing adequate external financing. Obviously, difficult judgments will have to be made in certain cases regarding how most effectively to catalyze external financing. The case of Costa Rica comes to mind, for example. But the Fund must continue to focus its efforts on these dual objectives. In that connection, I support Mr. Massé's view that we should continue to maintain the current policy on financing assurances.

The Fund will also need to continue to build on the progress it has achieved in collaboration with the World Bank. Both institutions should work closely together in their efforts to catalyze financing flows, because it is clear that one aspect of the evolution of the debt strategy in the past few years is that, while the importance of the Fund's role has not diminished in the eyes of the private financial community, the importance of the Bank's role has increased somewhat. The Bank and the Fund perhaps now play together a more complex role in catalyzing commercial bank packages than they did previously; this requires a new form of institutional collaboration that is not easy to achieve. Nevertheless, there has been some effective collaboration in the last year or two.

As the debt problem evolves over the period ahead, the increasing potential for arrears to the Fund and to the Bank could impair the ability of these institutions to effectively fulfill their roles in the debt strategy. The Fund serves as an anchor for the international financial system, and if the community at large believes this anchor is slipping--that the Fund itself is suffering serious financial problems--it will be difficult for the Fund to continue playing the role expected of it. Moreover, the arrears problem could impair the Fund's resource base and its ability to provide the financing needed to support sound adjustment efforts.

In conclusion, my authorities are encouraged by developments in the debt strategy over the past six months. However, they are not blind to the shortcomings and frailties that continue to exist in some areas of the strategy. We must use the flexibility inherent in the strategy to deal with these shortcomings while continuing to adhere to the basic principles which have guided us so far.

Mr. Salehkhou, noting that Mr. Dallara had included Tunisia among those countries which had regained access to capital markets, remarked that to his knowledge, Tunisia had never lost access to capital markets.

Mr. Dallara observed that Tunisia's status in the financial community was not entirely reflected in its access to financing. Indeed, Tunisia had improved its access through its adjustment policies, which had strengthened its creditworthiness. That increased access was only one example of the banking community's willingness to respond to the adjustment efforts of those debtor countries which persisted in implementing sound policies.

Mr. Dai made the following statement:

As I am in broad agreement with the staff's analysis, I will confine myself to emphasizing three points regarding growth prospects in the highly indebted countries, issues relating to debt reduction techniques, and the role of the Fund.

It is important to note the significant impact of the adjustment policies adopted by the debtor countries to address their external debt problems on their growth prospects. Since the outbreak of the debt crisis six years ago, the debtor countries have undertaken considerable measures aimed at a rapid shift in their external positions in order to adjust their economies. As a result of the ensuing contraction in domestic demand, the reduction of investment, and the compression of imports, the growth prospects of most debtor countries are questionable and unsustainable over the longer term, in view of the still difficult economic situation of some heavily indebted countries, especially in Latin America and sub-Saharan Africa.

Although this point has been fully discussed in staff reports and by the Board on previous occasions, I would like to emphasize once again that the external imbalances in many indebted countries are the consequence of an insufficient economic base and, in particular, their vulnerability to changes in the external environment. It is therefore clear that the key to the restoration of financial viability in these countries lies in adjustment that allows for viable economic growth on a sustainable basis rather than a temporary shift in their external positions. The staff's analysis of the past six years' experience again shows that a favorable international environment and adequate financial inflows are indispensable for the success of these countries' adjustment efforts. Unfortunately, such conditions have not fully materialized, and the resolution of the debt problem remains remote.

Although some of the debt reduction techniques summarized in the staff paper have been helpful in reducing the stock of debt of individual countries, most are subject to constraints. However, novel approaches and experimental schemes should be encouraged and implemented on a case-by-case basis if they can provide a breathing space to highly indebted countries, even though these techniques do not provide a basic solution to the debt problem. To develop further debt-reducing mechanisms and, at the same time, avoid their adverse side effects, it is important that creditor countries continue to show flexibility with respect to innovative approaches in the context of their regulatory, accounting, and tax provisions, and thereby create more favorable conditions and enable commercial banks to become more actively involved in debt relief operations.

The Fund should continue to play its central role in the management of the debt situation. It is true that the Fund's ability to support member countries' structural adjustment efforts has been strengthened through the establishment of the enhanced structural adjustment facility, the revitalization of the extended Fund facility, and the introduction of contingency financing. However, since most highly indebted low- and middle-income countries are still facing acute situations and since the problem of overdue obligations to the Fund is intensifying, the Fund should be more active and flexible in playing its catalytic role in support of the adjustment efforts of the indebted countries so as to help restore their creditworthiness and normalize relations between debtors and creditors. In this context, I agree with the staff that other possible areas where the Fund can make a contribution should be explored. The Fund should not only stand ready to provide assistance to members in need, but in view of the cooperative nature of the institution and its responsibility for international financial stability, it should play a more positive role in bringing all parties concerned together in a cooperative effort to implement fully the debt strategy.

Mr. Donoso made the following statement:

The staff paper concisely outlines the main aspects of the debt problem and raises the most relevant issues of concern. The staff's presentation clearly indicates that for the highly indebted middle-income countries, a realistic strategy has to encompass sound economic policies complemented by financial instruments that allow them to benefit from the discounts on their debt. I agree with this view.

There are three basic elements to the debt strategy. First, it is absolutely important that indebted countries implement policies aimed at improving their trade balance and that they contribute more of their own resources to service their external liabilities. In this way, debtor countries can contain the growth of their external liabilities and induce creditors to further help finance their debt burden. Second, and equally important, to assure that this process is carried out efficiently, economic reforms that are oriented toward the best possible use of existing resources and toward increased saving must be implemented so as to augment available resources. In this way, the generation of a larger trade surplus consistent with reasonable levels of consumption and investment can be achieved over time. Third, as financial markets have indicated for some time, the debt overhang is part of the overall problem. Therefore, mechanisms must be developed to allow countries to exchange debt instruments and benefit from the discounts on their claims in the process.

The representative cases analyzed by the staff clearly indicate the importance of complementary approaches to the basic elements of the debt strategy. However, the staff also acknowledges the difficulties of implementing an expanded approach to deal with the debt problem. Creditors are clearly reluctant to participate in the provisioning of finance to cover the current account deficits of indebted countries or to refinance amortizations which become due. The evolution of banks' behavior in the recent past poses a real problem to an expanded approach. Also, the staff emphasizes that although buy-backs offer an attractive option because they allow countries to benefit from the existing discount on their claims, use of this option would not reduce countries' debt to a level that would resolve the debt problem.

The staff's case studies provide a good orientation for the Fund's efforts in the debt strategy. More specifically, until the resources needed to allow countries to buy back old debt and benefit from the discount on their debt becomes available, countries must keep growing. Their standard of living has to improve, and the level of investment must be sufficient to assure that over time, there is some further improvement in their economic prospects. Thus, high priority has to be given to the problem of lack of cooperation on the part of creditors in helping to meet the financing needs of indebted countries.

There has been a particularly dramatic neglect on the part of creditors of the needs of very small countries. In this respect, the Board has discussed whether the Fund should undertake a more active role in helping debtor countries in their negotiation with creditors or by offering these countries protection from creditors reluctant to cooperate in supporting debtors' adjustment efforts, for example, through its use of the approval of restrictions. This issue has to be analyzed further, especially as the problem of smaller countries has become most pressing. Another area deserving analysis relates to ways in which those countries might gain access to the resources needed to undertake buy-back operations on a scale that would contribute importantly toward the solution of their debt problems.

I welcome the work already undertaken by the staff in this regard. Carlos Rodriguez's recent working paper on whether buy-backs financed with a country's own resources represented a real possibility for overcoming the debt problem ("The Strategy of Debt Buy-Backs: A Theoretical Analysis of the Competitive Case," WP/88/20; February 22, 1988) indicates that such operations could be beneficial if the market evaluation of the country's debt-servicing ability is excessively pessimistic. This analysis suggests that the success of buy-backs depends on first subordinating old indebtedness to the new indebtedness acquired to undertake the buy-back and then having access to resources to finance the operation.

Another recent working paper, by W. Max Corden, analyzes the feasibility of nonvoluntary involvement of all creditors in a scheme to reduce a country's indebtedness. This is a delicate topic, but if consideration is to be given to buy-backs and the use of discounts on debtors' claims in the secondary market as components of the debt strategy, studies should also be developed to determine whether existing institutions and mechanisms would allow for debt relief to make an important contribution to the solution to the debt problem.

The banks appear to understand the importance of this element. For example, the Mexican buy-back operation involved the use of the country's official reserves, and the banks agreed to their use for this purpose. Also, in the case of Chile, banks agreed to the use of the country's official reserves to buy back debt and to the country offering special "exportable assets" as collateral for new debt instruments to attract financing. Although the amounts involved were limited, these operations involved the recognition by the banks that new debt would have to be granted seniority treatment if the possibilities offered by buy-back operations are to be realized.

In sum, much remains to be done to better understand how the financial elements being added to the strategy should be implemented and how the Fund can better support their implementation. From this perspective, the in-depth study of the role that national authorities could play to ensure the adequate coordination of banking regulations or tax policies is important. In the meantime, the Fund must strengthen its efforts to assure the contribution of creditors in support of a debtor country's undertakings to manage appropriately its debt problem.

Mrs. Ploix made the following statement:

Before commenting on specific aspects of the staff paper, which focuses mainly on more technical aspects of debt management, I wish to make two general remarks. First, the development of innovative formulas designed to alleviate the debt burden is undoubtedly a promising avenue. However, without a reasonably stable and favorable international environment, all these efforts will yield little result. I will not dwell on some recent disquieting developments such as interest rate increases, renewed inflationary pressures, or continued protectionist drift. Nevertheless, these problems must be kept in mind during today's discussion.

As a second general point, I note that the staff paper hardly touches upon the poorest countries' situation. It should be mentioned that in 1987 and 1988 major initiatives were launched, and that the last of these, stemming from the Toronto summit, is currently being finalized and should result in significant debt relief.

My specific comments will concentrate first on some caveats regarding the blend of new money and debt reduction as suggested by the staff. I will then remark on the role of the Fund in the debt strategy.

First, on the blend of new money and debt reduction, it is clear that despite some substantial headway made in adjusting their economies, most debtor countries are still suffering from an excessive debt burden. In this light, it seems advisable at this stage to try to stabilize the absolute level of indebtedness. This could facilitate a resumption of growth that would, in due term, help to bring down debt service ratios to more sustainable levels.

New money packages that add to the stock of debt may then appear questionable. However, the usefulness of new money as a standard component in rescheduling agreements should not be overlooked. A first argument in favor of new money relates to the recent significant increase in interest payments arrears. Such a development means that the relationship between debtors and creditors cannot be normalized without the provision of new money for the elimination of arrears. A second argument has to do with the simplicity of new money financing: this approach will remain easier to implement, in terms of comparability of treatment and burden sharing among creditors.

With respect to debt reduction for middle-income countries, I would like first to recall my authorities' open-mindedness in this regard, so long as arrangements are market-based and freely negotiated between debtors and the banking community. However, the practical use of debt-equity, debt buy-back, and debt conversion schemes raises some questions.

First, the potential contribution of debt-equity conversion schemes is overlooked in the staff paper. Apart from the positive impact on the debtor country's external viability, one of the main objectives of debt reduction is to strengthen the cohesion within the group of creditor banks. To this end, banks without a long-term business interest in a country should be in a position to dispose of their claims. Debt-equity conversion schemes appear useful in this respect, as they constitute the main vehicle for transactions in the cash segment of the secondary market. Chile's remarkable experience in this area should be emulated by other larger debtor countries, whose potential in terms of direct foreign investment is even more promising.

Second, it should be recalled that the debt buy-back mechanism remains fraught with difficulty. It is true that another way of narrowing the size of creditor bank groups would consist in introducing selective, rather than overall, buy-back schemes. Actually the Bolivian experience is not easily reproducible, to the extent that the large majority of debtor countries wants to keep open their future access to capital markets. This leaves, in principle, the possibility for a country to buy back the claims held by a limited group of banks. However, such a selective buy-back scheme cannot account for a substantial fraction of the overall debt. Moreover, this approach seems likely to complicate transactions in the secondary market by debtor banks trying to rationalize their portfolios. I would appreciate any comment that the staff may have on this aspect of debt reduction, and specifically, on the case of Chile.

Third, some limitations inherent in debt-conversion schemes are also worth mentioning. For a few large debtor countries, a distinction between two categories of claim holders does not seem practical, because almost all creditor banks may consider that they have a long-term business interest in these developing economies. In this instance, a debt conversion mechanism may be envisaged. Nevertheless, past experience suggests that from the creditors' standpoint, the seniority of new claims over old ones is difficult to establish. From the debtors' standpoint, the gain in terms of interest payments appears modest and could even be disappointing if the flow of future interest payments were to be guaranteed.

As for the "critical mass" approach to financing assurances, my authorities see some merit in the staff's suggestion that more elaborate criteria for assessing the financial framework in support of a member's adjustment program could be used. However, they are also of the view that the very notion of "critical mass" is the only way to deter a growing number of banks from adopting the behavior of free-riders.

The setting up of new facilities and the revitalization of existing ones are crucial developments that signal the Fund's determination to fulfill its role in the growth-oriented adjustment process. The restoration of higher but sustainable rates of growth in indebted countries remains the best avenue toward alleviating the debt burden, and Fund-supported, supply-enhancing programs are to play a key role to this end.

But once again the burden-sharing issue has to be raised, in view of the fact that the more stringent capital adequacy ratios agreed upon by the Group of Ten countries could adversely affect the international lending activity of commercial banks. One way to deflect such an unwelcome development would be to encourage commercial banks to shift their financing activity from general purpose balance of payments loans to trade and project financing. Guarantees granted by creditor countries and cofinancing with multilateral development banks would be helpful in this respect, as they would allow a lesser growth of risk-weighted assets.

As regards the longer-term time frame required to promote structural adjustment, the Fund should remain aware of creditors' reluctance to commit themselves to multiyear arrangements. Thus, if the Fund is to continue to play a significant catalytic role, it should not overlook the yearly objectives formulated in its longer-term programs.

Finally, my authorities can go along with the staff's suggestions on the advisory role of the Fund. With respect to the determination of financing gaps, I wonder whether the Fund could envisage incorporating the reserves buildup that may be needed for carrying out debt reduction schemes.

The Chairman remarked that he had been somewhat surprised by Directors' concern that the staff's suggestion regarding the need to evaluate financial assurances in more qualitative terms than in the past ran the risk of weakening the Fund's policies in that regard. The need for a more qualitative evaluation was imposed by the growing complexity of the financing framework in support of members' adjustment efforts. Indeed, the staff agreed with Mrs. Ploix that financial assurances were useful to discourage a growing number of free-riders, and for so many other reasons. The Fund could not avoid introducing some judgmental element in evaluating financial assurances, but at the same time, it was absolutely necessary to maintain the Fund's policies with respect to those assurances, including the notion of "critical mass."

The Executive Directors agreed to continue 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/88/127 (8/25/88) and EBM/88/128 (8/26/88).

2. PEOPLE'S REPUBLIC OF THE CONGO, RWANDA, SOLOMON ISLANDS, AND SOUTH AFRICA - 1988 ARTICLE IV CONSULTATIONS - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the periods for completing the 1988 Article IV consultations with the People's Republic of the Congo, Rwanda, Solomon Islands and South Africa to not later than October 17, 1988. (EBD/88/238, 8/22/88)

Decision No. 8963-(88/128), adopted
August 25, 1988

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/88/212 (8/24/88) is approved.

APPROVED: February 23, 1989

LEO VAN HOUTVEN
Secretary