NOT FOR PUBLIC USE

0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/54

3:00 p.m., March 30, 1988

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

Executive Directors	Alternate Executive Directors
A. Abdallah	P. E. Archibong, Temporary
F. Cassell	C. Enoch
	Yang W., Temporary
C. H. Dallara	E. L. Walker, Temporary
J. de Groote	J. Prader
	E. V. Feldman
	A. M. Othman
G. Grosche	B. Goos
	J. Reddy
A. Kafka	J. Hospedales
M. Massé	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
	A. Ouanes, Temporary
G. Ortiz	L. Filardo
J. Ovi	M. Fogelholm
H. Ploix	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

Also Present

IBRD: A. G. Toft, Debt Management and Financial Advisory Services. African Department: M. Allen, G. Kuhn. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; E. Brau, K. B. Dillon, G. G. Johnson, H. B. Junz, S. Kanesa-Thasan, P. M. Keller, G. R. Kincaid, K. P. Regling, C. M. Watson, N. E. Weersinghe. External Relations Department: P. C. Hole. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; A. Cheasty. IMF Institute: O. B. Malalou. Legal Department: T. M. C. Asser. Research Department: J. A. Frenkel, Economic Counsellor and Director; N. R. Chrimes, W. M. Corden, D. Folkerts-Landau, P. Wickham. Treasurer's Department: D. Williams, Deputy Treasurer; W. L. Coats, Jr., S. I. Fawzi. Western Hemisphere Department: S. T. Beza, Director; C. S. Lee. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, W. N. Engert, A. G. A. Faria, K.-H. Kleine, P. Péterfalvy, G. Pineau, A. Vasudevan. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, J. R. N. Almeida, H. S. Binay, E. C. Demaestri, F. El Fiky, S. K. Fayyad, V. J. Fernández, B. Fuleihan, J. Gold, M. A. Hammoudi, C. L. Haynes, M. Hepp, L. Hubloue, J. M. Jones, M. A. Kyhlberg, T. Morita, J. A. K. Munthali, D. V. Nhien, C. Noriega, L. M. Piantini, S. Rebecchini, G. Schurr, G. Seyler, R. Wenzel, D. A. Woodward.

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

The Executive Directors continued from the previous meeting (EBM/88/53, 3/30/88) their consideration of a staff paper on developments, issues, and the role of the Fund in the management of the debt situation (EBS/88/55, 3/9/88; and Cor. 1, 3/29/88). They also had before them background papers on the experience with multilateral official debt rescheduling over the period June 1986 through December 1987 (SM/88/59, 3/9/88), on recent developments in commercial bank debt restructuring (SM/88/63, 3/15/88), and on recent developments in multiyear restructuring agreements and enhanced surveillance (SM/88/66, 3/18/88).

Mr. Rye made the following statement:

In view of the staff paper's brevity, clarity, balance, and appropriate focus on the key issues in the debt situation, I shall make only a few specific points. First, I would stress the key role of improved policy performance in the major industrial countries for the smooth resolution of debt problems. In my authorities' view, the major responsibility of the industrial countries is to adopt macroeconomic, structural, and trade policies that are conducive to stronger, sustained growth in the world economy and improved market access. This would enhance both the export opportunities and the debt-servicing capacity of debtors.

The current difficulties of restricted new lending by commercial banks and "adjustment fatigue" on the part of debtors would be considerably relieved by a more supportive international economic environment, including progress in removing restrictions on agricultural trade. This is not to say that appropriate policies in debtor countries are secondary or in some way contingent on policy change elsewhere; on the contrary, they are fundamental to a restoration of creditworthiness and a resumption of growth and development.

I also agree that differences between debtors--the basis of the case-by-case approach--must continue to be recognized, including in the further evolution of voluntary, market-based financing techniques. Table 1 of EBS/88/55 usefully highlights the sharp differences between the situations of individual heavily indebted countries. Some, including the Philippines, have made considerable progress on a number of fronts; others are obviously finding the going much harder. I wonder, like Mr. Cassell, why 1980 was chosen as the base year for terms of trade indices. For the reasons he mentioned, it seems singularly inappropriate to take the time of peak oil prices as the base year, and the staff should look for a more neutral base period.

I agree with the reasons given on page 2 of the main paper for maintaining the case-by-case approach, and indeed the lack of any real alternative. The search for what Mr. Dallara has called the "G" solutions is not merely vain, but actually counter-productive. Discussions of such nostrums may well be holding back the banking system from facing up to longer-term realities. So long as the prospect that creditor countries and their tax-payers may come to the rescue continues to be dangled before them, the banks have little incentive to look past the short-term, purely business-as-usual approaches which they have so far largely followed. It is, of course, a distraction also for the debtor countries.

It is true that the Bolivian buy-back scheme is an encouraging step toward reality--including the reality that, for a number of countries, debt relief or debt reduction will be inevitable. It is also, incidentally, a most interesting example of how the Fund can play a constructive role somewhat outside its normal framework. We must, of course, beware of any assumption that particular developments in particular countries--whether Mexico or Bolivia--necessarily provide answers relevant to the very different circumstances and needs of others.

Three further observations concern the commercial banks. First, it is questionable that the secondary market is necessarily a good indicator of the ultimate value of banks' claims on debtor countries. Fluctuations in the secondary market seem instead to reflect the shifting balance of the forces of supply and demand. In that regard, I would be interested to hear the staff elaborate on the reasons for the recent marked and persistent drop in secondary market prices and its implications.

Second, creditor governments have already made considerable efforts, through regulatory changes and tax breaks, to induce their banks to lend more to debtor countries. Yet the response has been largely disappointing. Here, I venture to take issue with Mr. Dallara. In terms of their net transfers to debtor countries, the banks have clearly fallen well short of expectations, and in this respect the Baker plan, and the debt strategy more generally, has not been put sufficiently into effect.

Third, there is a clear need for the decision-making processes of the commercial banks to be concentrated into the hands of those banks with real medium-term and longer-term interests in the debtor countries concerned. This need can, of course, only be resolved by the banks themselves, but I hope that the Fund would lend its support to any developments that will encourage such a process and thus enable negotiations between debtor countries and creditor banks to be simplified and speeded up, and generally to be made less agonizing for all concerned.

On the catalytic role of the Fund, there is a continuing risk that difficulties of burden sharing among private creditors and their reluctance to provide sufficient financing assurances for Fund-supported programs will put pressure on multilateral creditors to increase their own financial involvement beyond prudent levels. An important part of the answer to this dilemma lies in convincing private creditors that policy measures in debtor and creditor countries will, in fact, strengthen debt-servicing capacity and creditworthiness, in line with indebted countries' program objectives. This perception will only take hold if stop-go policy implementation is replaced by consistent policy performance. In such an environment, nondebt-creating private inflows to debtor countries will also be encouraged--a most desirable development.

I have no real problem with the five points on possible functions of the Fund set forth in the main staff paper, but I would underline the introductory caveat "under circumstances where this was fully justified by the quality of policies." I would add also that there must be confidence, based on past performance and, where appropriate, prior actions or front-loaded programs, that the countries concerned are not only willing to enter into commitments to quality programs, but are able to carry them out over a period of three to four years. I am afraid, looking over the world scene today, that the number of such countries is depressingly small, and until that situation changes for the better, the Fund will, for the most part, have to maintain its traditional emphasis on short-term programs, necessarily with more limited objectives.

I also have a great deal of sympathy for Mr. Posthumus's view that the Fund can, in appropriate cases, exert a catalytic influence by withholding its support or, as Mr. Massé suggested, by taking a lower, rather than a higher, profile.

Finally, I agree with the staff that the Fund should "take care to keep its own financial involvement in countries with strong programs at a level that helps fulfill its catalytic functions." This approach rightly puts the emphasis where it belongs--on a country-by-country assessment, not on some overall view of the appropriateness of the Fund's total net lending position.

The Chairman observed that once a country was ready to embark on an effective program, the hesitation of commercial banks to participate in financing packages and the resultant protracted negotiations could lead to substantial delays in the implementation of a member's adjustment effort. In that situation, the country might start financing its balance of payments gap through the accumulation of arrears. Once that occurred, adjustment would be suspended, which was bad for the country, for the debt strategy, and for the Fund-supported program. Moreover, in the absence of a strong, supportive domestic constituency, the authorities might face tremendous political difficulties in implementing strong, front-loaded adjustment measures once reliance on arrears weakened the rationale for such measures. In those circumstances, how did Mr. Rye see the Fund's catalytic role?

Mr. Rye remarked that there was no satisfactory answer to the dilemma posed by the Chairman. Countries would be forced further into arrears if commercial bank financing was not forthcoming in due time. However, it did not seem to make a great deal of difference in those circumstances whether the Fund filled some small part of the financing gap. The country would be only a little less in arrears, while the Fund might be putting not only its resources, but even its general character as a short-term balance of payments financing instrument, at risk. Moreover, it was not clear that the suspension of adjustment would follow the accumulation of additional arrears. It would not be in the country's interest to set aside its adjustment process, especially if there was some prospect of reaching an accommodation with the banks in the near future.

Mr. Massé considered that a large amount of the debt would be financed through arrears in the future. The maximum amount of debt that could be financed from arrears would be equivalent to the flow needed in terms of net interest payments on banks' refinancing of the original interest payments due them. That flow would not prevent adjustment, but it might force an even more difficult adjustment on countries than might occur under a Fund-supported program, because the accumulation of additional arrears would necessitate a reduction in total internal consumption.

The Chairman commented that that would really be pushing a country to disaster.

Mr. Posthumus remarked that in the situation envisaged by the Chairman, he would prefer that the Fund adopt a wait-and-see approach, because waiting was more effective than acting in that situation. One option might be for the Fund to say to the banks that it would not move until it had received a clear sign from them that they were likewise prepared to move.

Mr. Al-Assaf asked whether the Fund had the resources to fill the financing gap that was being left by the banks. There was a danger that if the Fund became more involved in financing, the banks might withdraw even more.

The Chairman observed that the Fund was not, in fact, becoming more involved in filling members' financing gaps. Actual average access to Fund resources had been reduced to 39 percent in 1987, and reflows to the Fund had amounted to about SDR 6 billion. Those were not at all signals that the Fund was bailing out the banks. The question instead was, what should the Fund do if the banks retreated further from financing in the future? The consensus seemed to be that the Fund should assume a hands-off position during creditor-debtor negotiations in order to make clear to the banks that the Fund was prepared to play its role in the debt strategy only once the banks had assumed their responsibilities in that strategy.

Mr. Feldman remarked that he supported Mr. Massé's view that financing debt through the accumulation of arrears might lead to an even more difficult adjustment situation for debtor countries, especially if it led to capital flight. In that event, the initial response of the authorities might be to tighten monetary policy, which would result in higher interest rates than would otherwise have been necessary.

The Chairman noted that the "adjustment" described by Mr. Massé and Mr. Feldman involved the curtailment of investment and imports in the debtor country, but did not constitute the growth-oriented adjustment being promoted by the Fund. In fact, the resulting compression of investment and imports would lead to a precarious economic situation. In his view, the consequences of reduced or inadequate financing should not be called adjustment; adjustment signified some qualitative improvement in the working of the economy.

Mr. Massé remarked that while he would prefer effective adjustment to ineffective adjustment, the ineffective adjustment he had described would occur if the Fund failed to intervene. The justification for intervention by the Fund was that it could, through advice and leverage--including financing--encourage effective, growth-oriented adjustment. Since financing through arrears was likely to occur in the future, he would appreciate more information on how the Fund could intervene to ensure that the adjustment that took place was indeed effective.

Mr. Ovi observed that in any economy undertaking adjustment there was some compression of investment and increase in interest rates in order to promote more efficient use of the investment that remained. That was an important part of the adjustment process. However, he agreed that in the extreme, such compression no longer constituted adjustment.

Mr. de Groote made the following statement:

> A few misunderstandings regarding the debt situation have to be dispelled. The first misunderstanding is that the Fund and the Bank could in the immediate future set up a global debt relief scheme on which there would be a consensus. Although such schemes are conceivable, and many of us even find them attractive, further discussion of this issue carries the risk that meanwhile other important possibilities would be neglected. That risk is especially high owing to the expectation raised in the U.S. Congress that a global solution is at hand that would miraculously alleviate the burden for debtors and banks alike, and induce the latter to resume lending. Similar ideas are being floated in Europe and have found their way to parliaments. In the interim, banks have adopted a wait-and-see attitude, which has prevented them from playing their role in the debt strategy, while governments have also been tempted to wait for a Fund solution to the debt problems of low-income countries, realizing themselves that these schemes would ultimately shift the burden to themselves.

Attractive as these schemes may be, in the immediate future priority should continue to be given to the growing-out-of-debt strategy. That strategy, in fact, has already led to some important results, and further steps can be taken that are likely to lead to a renewal of spontaneous bank lending.

Another misunderstanding is that there is a choice to be made between debt accumulation and debt reduction. Both can coexist in a single global strategy for growing out of debt, with each having a different role in different circumstances. Debt conversion techniques can play an essential role in an interim phase of adjustment in order to re-establish the creditworthiness of the country, and in a later phase, debt accumulation can play a part.

In this regard, the Board's discussion on the debt situation has led to a few conclusions. First, a country's debt overhang must be reduced before a recommended adjustment solution can be attempted. Debt levels that approach or exceed nominal GDP impose an interest service burden that cannot be reconciled with the maintenance of even minimal growth and adjustment. However, at about 60 percent of GDP, the average debt ratio of the most heavily indebted countries is still below the critical level where the capacity to grow out of debt is assumed to become problematic, and the relative debt levels of the few systemic borrowers have gradually been stabilized or even reduced since 1983.

As for individual countries' debt behavior, the countries with the highest debt to GDP ratios are those in the lowest-income category for whom some form of debt relief is already gaining acceptance. Thus, the argument that outstanding debt is too high cannot be presumed to apply to most of the highly indebted countries. It does definitely apply to some low-income countries: the average debt/GDP ratio of the low-income African countries, at 86 percent, has been growing rapidly every year since 1980, contrary to the evolution of debt ratios in the medium-income debtor countries. Domestic savings in these countries for the foreseeable future will remain low. Thus, they could not achieve a high level of structural growth and at the same time service their heavy interest burdens without some type of specific assistance. Fortunately, it is now generally accepted that these countries could grow out of debt only if they obtain relief from their high debt service burdens, a goal already being addressed by the enlargement of the structural adjustment facility and by proposals for refinancing part of their debts through loans at concessional rates and with concessional reimbursement periods. Therefore, Mr. Cassell's suggestion on this point has to be strongly supported and could be an important conclusion to be submitted to the Interim Committee.

A second conclusion deals with debt conversion. Until the minimum additional financing flows needed for orderly debt servicing are resumed, it is useful to explore more systematic ways of exploiting the discounts on claims in the secondary markets so as to improve countries' creditworthiness through debt conversion techniques. Such techniques are not the solution to the debt problem, but might be a component of the growing-out-of-debt strategy. However, the effects of debt conversion or debt reduction on countries' creditworthiness are not easy to analyze. The syndication of debts--the usual technique for conducting debt conversions--can have a positive effect to the extent that it shifts the claims to creditors who are more willing to hold them. But apart from this positive side effect, it cannot be assumed that in principle, debt conversion in itself will significantly affect the banks' willingness to commit new funds. Positive reactions by the banks can be expected only if debtors obtain a debt-servicing profile that better corresponds to their ability to pay; this is a crucial element--the reduction of the country's outstanding debt obtained through conversion at a discounted value will alleviate debt repayment obligations and increase the resources available for investment only to the extent that the debt was otherwise not expected to be rescheduled or rolled over. But experience suggests that the banks are unwilling to reschedule or renew their nominal debt holdings as long as the interest on those debts is paid. It is therefore necessary to focus efforts on reducing the debt service.

The debt-bond exchange for Mexico was extremely instructive in this regard. The net interest flows resulting from this scheme consist of a small flow of interest payments on reconverted debt and the investment income on reserves that had to be set aside as collateral for the newly created debt obligations. Together, these two components may be less--perhaps not much less--than the full interest payment on the original debt. These considerations perhaps explain why the success of the Mexican operation fell somewhat short of initial expectations, and why the banks have generally preferred to hold the bulk of Mexican claims rather than accept larger losses in exchange for limited improvement in Mexico's capacity to service its remaining debt obligation.

Debt conversion techniques have to aim at the reduction of the interest burden either directly or indirectly. In this context, attention has to be given to allowing debtor countries which are following a convincing adjustment program to benefit from credits or higher reserves so as to assist them in repurchasing their debt. The question is: what can be done to help countries increase their reserves, maintain more appropriate reserve levels, or gain access to credit in a transitional phase, in preparation for the implementation of a full-fledged growing-out-of-debt strategy aimed at restoring their creditworthiness?

The problem of subordination arises in the context of debt conversion, and mandatory subordination is likely to be counterproductive and difficult to achieve in the present circumstances. But if creditors can voluntarily accept subordination in an overall agreement, then debt conversion can play a positive role in the debt strategy. Account also has to be taken of Mr. Dallara's "mariposa" problem: an aggressive approach to pursuing secondary market discounts can be counterproductive. But it should also be acknowledged that discounts exist, and that the banks have taken those discounts into consideration implicitly, even if they have not always acknowledged them explicitly. It can therefore be concluded that there is no major contradiction between the present debt strategy and debt conversion techniques: they belong to the same general process, and debt reduction is but one phase of that process.

The present strategy, based on the achievement of high rates of growth and increased export capacity, is certainly the best possible solution for restoring countries' debt-servicing capacity and creditworthiness. Moreover, the outstanding debt levels of the most heavily indebted countries do not seem too high to be serviced, if moderate financing flows can be restored. The restoration of those flows should therefore be given priority. There is, in principle, no reason to suppose that the reduction of debt levels would not produce a resumption of bank lending over time.

In this regard, the experience of one country that has successfully grown out of debt is particularly illustrative. In recent years Turkey has implemented a strong and courageous adjustment program that combined structural and demand-management elements from the outset. The program was also strongly financed by the Fund. My Turkish authorities would never have been able to consider the implementation of such a program if they had not had the certainty from the outset that the Fund was ready to help them.

It should also be remembered that it was two years before Turkey recovered its spontaneous access to international financial markets. And if the Federal Republic of Germany and Saudi Arabia as well as other OECD countries had not intervened strongly at the time to assist the country, there would have been no Turkish program whatsoever. The point is, there is no way to set constructive adjustment programs into operation, including perhaps also debt conversion elements, unless there is some certainty at the outset that it is financeable.

As for the role of the Fund and the banks in the early stages of setting up and financing a program, I am attracted by Mr. Posthumus's extremely constructive suggestion that the Fund might possibly show some reluctance to provide its own resources in order to drag the banks back into negotiations on a financing package. Of course, that trick may no longer work as well as it has in the past because the risks for the banks are not as great as they were previously. A more seductive approach would be to give more attention to the banks' own interests in favorable economic conditions in Latin America, which is a theme developed by Mr. Sengupta in his interesting paper on debt relief.

Although it is agreed that for the low-income indebted countries, concessional assistance and exceptional refinancing is needed, we cannot dismiss the possibility that despite all these efforts, recurrent commodity market weaknesses could continue to saddle these countries with export growth levels below the interest rate level on their rescheduled debt, thereby preventing them from ever growing out of debt. Therefore, proposals for refinancing a portion of their debts at concessional rates have to be considered, but these proposals have received a cool reception because of the costs they impose on the governments of creditor countries. Nonetheless, these preoccupations have to be reconsidered. It is also possible, as an intermediary step, that these governments might consider linking interest rates on outstanding debt to export price developments in the primary commodity markets. For instance, it might be possible to introduce a contingency clause on interest rates in rescheduling agreements with the Paris Club. Refinancing at concessional rates would not be promoted, as a general principle, but could be envisaged for low-income countries where persistent export weaknesses require exceptional measures to protect adjustment programs against balance of payments shortfalls.

Another possibility is that debt conversion schemes could play a more significant role if they focused more closely on rehabilitating countries' outstanding capital stock. The discounts on a country's debt reflect in many instances the market's fundamental concern over the poor productivity performance of outstanding capital stock. The pursuit of a more systematic conversion of debt into equity or bonds in connection with the rehabilitation of poorly performing investment sectors could help relieve this concern. It would also clearly be in the creditor's interest to obtain, on the completion of such schemes, a claim backed by better productivity performance. Debtors would no longer have to divert productive resources toward the servicing of nonproductive debts. And the World Bank, as the appropriate agency for supporting such operations, would obtain a major opportunity to rehabilitate its own role in the debt strategy as well as some segments of the indebted country's economy by, for instance, supporting privatization.

Such a scheme could be implemented along the following lines. With the assistance of the World Bank, the debtor government and its foreign creditors would isolate from the country's stock of external debt obligations those debts which could be assigned specifically to the domestic enterprise to be rehabilitated. The rehabilitation itself would be conducted with intensive technical and financial support from the Bank, within the framework of a Fund-supported adjustment program. In some countries, it would be easy to isolate projects that have absorbed about 50-60 percent of the total debt and to which the service of that investment could be assigned, not necessarily by privatizing them, but by isolating them in the form of separate responsible entities, and thereby alleviate the debt burden.

The efforts of the present debt strategy to restore confidence could be substantially strengthened, if they were coupled with an allocation of SDRs to improve the reserve position of debtor countries. Apart from its general positive impact on debtors' creditworthiness, an allocation of SDRs would increase the effectiveness of debt conversions. Experience with debt conversion schemes shows that a country can approach the banks with such schemes only if it has enough reserves either to buy back its debt at a discount or, like Mexico, to collateralize its reconverted debt obligations. An SDR allocation would provide debtors with the reserve resources needed to gain access to such schemes at lesser cost and for larger amounts than can otherwise be obtained and would thereby enhance both the attractiveness of debt conversions and the potential contribution of these conversions to the growing-out-of-debt strategy. Therefore, the issue of an SDR allocation needs to be considered in that context.

The benefits of an SDR allocation to the debt strategy would be considerably enhanced if the allocation was based on the principles of conditional SDR use. This approach would both increase the amount of SDRs available to debtor countries, since they would have at their disposal SDRs rechanneled from industrial countries to the Fund, and link the Fund's support of debt conversion and debt rehabilitation schemes to formal commitments to adjustment policies. Finally, it would protect the international community from protracted negotiations on the large transfer of resources that the establishment of a global debt facility would necessarily involve, and from the risk that rumors of an imminent solution would postpone indefinitely the banks' willingness to take up their assigned role in the strategy. These potential benefits are among the reasons why the Managing Director's proposal for an SDR allocation of SDR 20-30 billion should be supported.

In response to a question on the arrangement for Turkey, Mr. de Groote recalled that it was a stand-by arrangement with enlarged access in that it was understood at the outset that the arrangement would be renewed over a number of years. The Turkish authorities had not opted for an extended arrangement because they considered that such arrangements were intended for developing countries. However, in view of the nature of the program, it could have been supported by an extended arrangement with the Fund. In fact, on the occasion of the first review of the stand-by arrangement, there had been serious discussion with the authorities on whether to change it into an extended arrangement. For purely perceptual reasons, the authorities chose to continue with a stand-by arrangement.

Mr. Yamazaki made the following statement:

Before examining in detail the individual points raised by the staff, I would like to state the fundamental support of this chair for the thrust of the main staff paper.

This discussion provides a timely opportunity to reflect upon the current debt situation as well as to review the evolution of the debt strategy. It is worth reiterating that significant progress has been made in subduing the debt crisis. However, it should also be noted that the economic performance of the indebted countries has not improved as strongly as was expected, even though their current account positions have substantially strengthened.

The positive prospects for the future presented in the report on the world economic outlook are no doubt encouraging. The noninflationary growth of the industrial countries and the expansion of world trade will underpin the economic growth of developing countries. Nevertheless, the emerging adjustment fatigue not only in the indebted countries, but also among creditors, especially the commercial banks, is a major source of concern and underscores the importance of maintaining the momentum of efforts to resolve the debt problem.

There is no sweeping solution for the debt problem. Steady efforts based on the case-by-case approach are the only key to sustaining the confidence of both creditors and debtors in the debt strategy as well as to encouraging creditors and debtors to make further efforts.

In this context, I would like to stress the important role that the Fund has played, and will play, in resolving the debt problem. The fundamental basis of the debt strategy is the strong commitment of an indebted country to an effective adjustment policy. This focal point underlines the need to develop a stronger debt strategy centered on the Fund to help indebted countries design, and comply with, an effective adjustment program. Needless to say, the catalytic role of the Fund also points in this direction.

One lesson to be learned from the world economic outlook exercise is that a diversity of problems confronts different groups of countries. It is essential to differentiate the debt strategy based upon this diversity of problems, and in particular, to develop different approaches for low-income countries and middle-income countries. In saying this, I should emphasize the significance of recent developments in the middle-income countries. In particular, I strongly support the efforts of heavily indebted countries to resume cooperative relationships with the Fund and other creditors. These efforts will reduce the tensions associated with the debt problem and set us on the way to its resolution.

It should also be noted that innovative approaches have been developed within the menu approach, as illustrated by the Chilean debt-equity conversion and Mexican debt-bond exchange. It is essential that the debt strategy evolve further in this direction for middle-income countries. However, it should be stressed that the heavy burden of outstanding debt of middle-income countries warrants the effectiveness of a market-based approach rather than budgetary contributions from creditor countries.

New money will continue to play a major role in providing cash flows to indebted countries, and I agree with the staff that heavy reliance on postponing repayments as an alternative to balance of payments financing is inappropriate, especially for those countries which are already heavily indebted. Therefore, it would be most useful to develop debt reduction options in the menu, while recognizing that the scope of those options is limited. The diversified interests of creditor banks also illustrates the further need to expand the menu approach. Moreover, the development of the menu of financing options would help to create the impetus for further efforts on the part of both creditors and debtors.

In this context, the staff's views merit further reflection. In particular, I agree with the staff that it would be appropriate to exploit an extension of the Mexican debt exchange scheme. Here I would suggest that the scheme should be developed in such a way that the international financial institutions, particularly the Fund, would play the pivotal role in enhancing its scope, which is limited. I would also suggest that further study is needed on ways to accommodate indebted countries with depleted reserves. However, I hasten to add that the menu approach should not be overestimated as a solution to the debt problem.

As to Paris Club reschedulings, there is merit in the staff's suggestion to provide medium-term support through a multiyear framework agreement in conjunction with the extended Fund or enhanced structural adjustment facilities. However, I would stress the need to retain the case-by-case approach, since the burden of rescheduling official debt falls on the taxpayers of creditor countries. I also would like to make it clear that my authorities have already improved export credit terms in recent years.

In conclusion, progress has been made in the management of the debt situation, but much remains to be accomplished. The Fund will have to continue to play a central role in the debt strategy as a catalyst, as well as a lender. In this context, I am in general agreement with the staff's views. I have already expressed my support for the Managing Director's proposal to revitalize the extended Fund facility. In negotiations between creditors and commercial banks on debt rescheduling or new money packages, the Fund should play an active role in providing appropriate advice, or, where necessary, as an intermediary with a view to expediting the completion of negotiations. Moreover, I would suggest that the Fund might play various other roles, on a case-by-case basis, within its jurisdiction.

Mr. Ovi made the following statement:

I fully agree with Mr. Rye that a satisfactory overall macroeconomic policy stance is the single most important factor in dealing with the debt problem. Also, this remains the responsibility of the major industrial countries.

My authorities are in general agreement with the staff's illuminating description of the continued serious debt situation. The Nordic countries share the staff's view regarding the need for gradually adjusting the debt strategy in the light of changing circumstances, and with due regard to the different situations of specific countries, or groups of countries. This last point needs to be emphasized. The degree of adjustment taking place, and the size and structure of foreign debt differ so much from one country to another and from one region to another that a centralized, uniform solution to the debt problem has to be ruled out. Indeed, one of the consequences of repeated and continued discussions on different kinds of more sweeping international debt facilities may well be to reduce the incentive for market participants to move forward with concrete actions in this area.

The Nordic countries maintain the view that all parties involved--debtor countries, industrial countries, commercial banks, and multilateral organizations--have a common responsibility to find and formulate solutions and that these solutions, however partial, should be based on voluntary, negotiated arrangements.

In all circumstances, the cornerstone will have to be economic adjustment in debtor countries that will ensure a stable balance of payments development over the medium term and, at the same time, support growth. Economic growth is, no doubt, crucial for the successful implementation of the debt strategy. Only growth can provide insurance against adjustment fatigue. In this situation, it would be incumbent upon the Fund, if and when requested, to assist debtor countries in the design of policy programs, to monitor the execution of these programs and to contribute to external financing both through its own resources and through the catalytic effect of Fund programs on both private and official lending. The actual choice of facility--whether a stand-by, extended, or structural adjustment arrangement--would depend upon the country's specific circumstances, such as its track record, or its ability to establish medium-term programs, and so on. The conditionality to be applied in each case should always be based on the achievement of balance of payments viability in the medium term. This viability is, at the same time, a necessary condition for assuring that adequate financing from other sources is forthcoming.

The recent experience of countries unilaterally withdrawing from cooperating with their creditors has clearly underscored the costs associated with that policy, including increased difficulty in obtaining trade credits and higher borrowing costs, as well as increased problems in negotiating debt rescheduling. The risks for the international financial system as a whole stemming from this more confrontational policy also should not be underestimated.

As the debt ratios for many countries are already high, it does not seem advisable in all instances to routinely cover future financing needs through additional debt accumulation. Consequently, other avenues need to be explored.

As regards the poorest countries, the approach seems to be fairly straightforward, as it appears necessary to enhance--above all--the amount of concessional financing.

The situation is more complicated for the middle-income countries, which can roughly be divided into two categories. The first, which is by far the smaller, includes countries which seem to have a reasonable chance of regaining access to international capital markets within the not too distant future. The other category can, however, be expected to experience protracted, deep-rooted balance of payments problems, necessitating a certain amount of new borrowing or some form of alleviation of the debt burden, and in some cases, even debt reduction. This assistance should, wherever feasible and through voluntary channels, be combined with new market-based instruments adapted to the prevailing circumstances. These instruments could contain elements of both debt burden alleviation and the simultaneous enhancement of foreign direct investment.

In the pursuit of new financing techniques aimed at reducing the stock of debt--such as, for example, the Bolivian buy-back scheme--the Fund could, no doubt, play a useful role. Also, to improve and facilitate commercial bank participation in such new schemes, tax and supervisory regulations in creditor countries may need to be amended. However, debt relief should never be applied in isolation but should be part and parcel of, and provide incentives for, comprehensive growth-oriented adjustment programs. In judging the scope for further possibilities in this area, I would find it useful if the staff could supply information on the latest developments in secondary markets for debt, including an assessment of the extent to which small and regional banks are reducing their exposure and thereby leaving this market more stable than it has been in the past.

The problems relating to capital flight also need to be addressed, particularly by the debtor countries themselves. The importance of a proper macroeconomic policy stance and growth-oriented structural reforms remain key factors in attracting the return of flight capital. How can the investors in third countries be expected to believe in a debtor country's policies if the country's own citizens do not?

On the question of the role of the Fund, it is important that the Fund maintain, or indeed strengthen, its independent role and not assume the role of any sort of guarantor in relation to commercial banks. Furthermore, I would like to underscore that a "critical mass," or other indisputable assurances of banks' participation, should also henceforth--as the main rule--be a requirement before the effectuation of Fund-supported programs: the application of "exceptional treatment" should be extremely restrictive.

I listened with great interest to Mr. Massé's remarks on the role of the Fund. I found his statement most thoughtful, and the kind of trend in the thinking of his authorities has certainly also been quite noticeable in my countries. As can be seen from my recent interventions in Board discussions, my authorities are attaching increasing importance to the design and quality of Fund programs, whereas they should like to see some disengagement of the Fund in terms of directly pressuring commercial banks into participation in financial packages.

I agree with the Chairman that the intermediary role of the Fund in this regard is basically a matter of degree--where we are on a scale and where we are moving. In this respect, the statement on page 8 of the main staff paper that the Fund could "assist the country in negotiating with key creditors a financing plan..." seems to suggest a more interventionist role than the Fund has played so far, which is contrary to what my authorities should like to see.

I would like to add a few points using the black-white approach adopted by most speakers in this debate. The Fund should continue to identify the financing gaps of member countries. It should establish what the appropriate economic policies of the country may be or--as suggested by Mr. Posthumus--even prepare a number of scenarios for various policy mixes. The way the financing gap is filled should basically be left to negotiation between the country and its creditors. The Fund should not seek to lessen the responsibility of banks to form their own judgment on a country's economic policy stance, debt-servicing capacity, and so on.

I realize that in a transitional period the inevitable result of this approach will be delays in agreeing to financial packages and even the accumulation of arrears by debtor countries. But this is not the decisive point. The relevant question is whether the withdrawal of the banks from financing is going to be transitional only or--at the other end of the spectrum--indeed, unavoidable. If the latter is the case--and here I agree with Mr. Massé--we should be careful not to sacrifice too many Fund resources in the process.

The Fund often tells debtor countries that one important reason for their not having regained creditworthiness in private capital markets despite strong adjustment could well be that their variable attitudes and their rhetoric vis-à-vis capital markets creates fundamental uncertainty. Similar arguments could perhaps be applied to the role of the Fund. If commercial banks have come to expect that great pressure will have to be exerted upon them in order to achieve their participation in financial support packages, or that the Fund will ultimately step in ahead of them, hesitation by the Fund in some cases will not bring about a change in how commercial banks perceive the role of the Fund, or how they behave.

Mr. Al-Assaf made the following statement:

The issue under discussion is a difficult, yet timely one. As the main staff paper indicates, the debt situation has moved from crisis management to an emphasis on the achievement of medium-term viability. The debt situation has now reached a turning point at which it is useful for all participants in the debt strategy to take stock of the experience of the past few years and to plan for the future. In my view, two important considerations need to be taken into account in an exercise of this nature.

The first is the diversity of situations in the highly indebted countries, five years after the sudden emergence of the debt crisis. Some countries have made impressive progress, others are making efforts that, if sustained over the medium term, could lead to a gradual improvement of their external position, while a few, unfortunately, do not appear to be moving decisively toward a solution to their problems.

The second consideration is the evolution of the attitude of commercial banks. It is increasingly clear that banks are becoming reluctant to participate in traditional financing packages. In their view, the continued injection of new liquidity only compounds the medium-term difficulties of the beneficiaries and directly increases their debt burdens. The new attitude of banks is best reflected in the menu approach. Because the success of that approach depends on market-determined decisions, it implies a return of confidence in the economic policies of the countries concerned. To a large extent, the future success of the debt strategy will be closely linked to the pace of progress in the return of confidence.

The role of the Fund, based on these two considerations, should be an important one. It would imply working on four key issues.

The first issue is the adequacy of program design. More than ever, Fund-supported programs for highly indebted countries should be based on credible, clear, and achievable objectives. In all cases, a fundamental precondition of the Fund's direct involvement should be the strong commitment of the authorities themselves.

The second issue, partly related to the first, is the encouragement by the Fund of a set of policies for indebted countries most likely to promote the return of private confidence and economic efficiency. For many of these countries, the best approach seems to consist of the adoption or intensification of outward-oriented growth policies and the development of a strong private sector.

The third issue centers on the promotion of a more open, stable international environment. In view of the fundamental importance of increasing the market shares of indebted countries' export products, the issue of protectionism is an integral part of the debt strategy. Therefore, a closer focus on this issue by the Fund is highly warranted at this stage.

The fourth issue is the best way to deal with those highly indebted countries for which market-based solutions appear impractical for the time being. The Fund has already taken a major step forward in addressing this issue for low-income countries through the enhancement of the structural adjustment facility. The Fund and the World Bank will have to play a key role with respect to these countries. In particular, the Fund will have to further reflect on the difficulties faced by countries that have been declared ineligible to use its resources.

In sum, it is important to realize that the role of the Fund has to be adapted to reflect the changing circumstances in which the debt strategy has to be implemented. Clearly, the catalytic role of the Fund is, and will remain, important. Immediately after 1982, Fund financing and associated financing from banks and other creditors were, of necessity, closely interdependent. Today, the degree of direct influence the Fund can have on the commercial banks' involvement in a financial package determined by market considerations may, in comparison, seem to be somewhat smaller than it was previously. But that does not necessarily mean that the catalytic role of the Fund itself has diminished. The Fund continues to have a crucial role to play through assisting its members in the design and implementation of adjustment programs and promoting a favorable international economic environment.

Mr. Sengupta made the following statement:

The central message of the staff paper on the debt situation is that if the indebted countries have a framework of effective policies to achieve external viability, they would be able to provide confidence to the private sector, help catalyze sources of financing, and bring about a better normalization of relations between creditors and debtors. Access to spontaneous resource flows can occur, in the staff's view, if indebted countries pursue strong adjustment policies. While adjustment is essential for gaining external viability and has in certain cases--for example, Brazil and Mexico--led to improved current account positions immediately after the debt crisis of 1982, the debt problem remains a major problem.

The continued existence of the debt problem, which has often been aggravated in recent years, is not only, or even primarily, due to weak and uneven policy implementation in debtor countries. Instead, it continues owing to many other factors affecting debtor countries, including the external environment, the increase in real interest rates, the deterioration of the terms of trade, the slow growth of external markets with the increase in protectionist tendencies, and the existence of a large debt overhang accumulated by debtor countries at a time when the world was quite different. In recent years there has been a large withdrawal of external financing, so that countries with high stocks of debt find it difficult to service their obligations and at the same time pursue investment activities. Although the staff recognizes these factors, it appears to prefer to address the problem through policy adjustment.

It is one thing to argue for adjustment, and altogether another to ensure that resources are catalyzed and new money flows take place. The staff refers briefly to the menu of financing options and seems to favor debt-equity conversions, debt buy-backs, and debt-bond exchange schemes as the key items that would help blend new money with debt reduction. I am sure that the staff is aware of other proposals that have been floated in this context, even if it chooses not to take cognizance of them.

With regard to official creditors and increasing the Fund's exposure in the context of the banks' declining exposure, the staff argues that appropriate ways of judging equivalence need to be developed. It is not clear what "equivalence" means; I would appreciate some clarification on his point.

The catalytic role of the Fund, the staff states, is to help countries design and implement economic policies that are sufficiently strong and comprehensive to restore both growth and the credibility of the targeted medium-term external viability. But it is becoming increasingly evident that such catalysis does not take place if the Fund's own financial commitments are limited or perceived to be so. In this connection, I welcome the Fund's initiative to enhance the structural adjustment facility to address the needs of low-income countries. I also agree with the staff that provision of new financing with a sufficiently large grant element would be crucial in cases where creditors are not in a position to reschedule a country's debt on concessional terms.

With regard to the middle-income debtor countries, the staff argues for Fund support through an extended Fund arrangement as an element of the strategy. I agree with this, but there is an important caveat: the extended Fund facility is intended to support structural adjustment over a longer time period than other facilities, such as the stand-by facility, which supports policies aimed at stabilization. The extended Fund facility would give confidence to bank creditors and private investors in a country's adjustment efforts if the country's problems are related to structural adjustment. For a good many indebted countries, it is true that structural change would help them to obtain higher growth rates and gain in terms of export diversification. But it would be necessary for the staff to demonstrate convincingly that structural measures are necessary for an appropriate adjustment and that simple stabilization measures would not be sufficient. It is quite possible that for some countries, stabilization is required, so that a stand-by arrangement, or perhaps repeated stand-by arrangements over a number of years, will be needed. This approach is the only way to build up confidence, for unless a distinction is made between structural adjustment under a three-year extended arrangement and stabilization under successive stand-by arrangements, the credibility of the extended facility will be lost.

I agree with Mr. Ortiz that the extended facility could be helpful in catalyzing bank financing for the indebted countries, not only because it commits Fund resources for three years but mainly because it tries to redress the structural aspects of adjustment problems. However, the extended facility should not be used for the purpose of catalyzing additional financing; if the problem is one of stabilization, successive stand-by arrangements are called for.

I would have liked to see the staff approach the debt problem by focusing on the basic theme of the Baker strategy, namely, that a viable solution should be built on adjustment measures that ensure a reasonable rate of growth. That approach not only would have given the proper context in which to show why the extended facility is helpful for solving the debt problem but also would have highlighted why some approaches are more suitable than others. It would have helped us to choose, from the menu of solutions, that one which would allow a country to increase its rate of investment and the growth of productive capacity and, in turn, increase its repayment capacity. It is not enough to say that debtors should not default on their obligations, or even to stop the current reverse flow of resource transfers. The solution to the debt problem has to be built on a strategy aimed at increasing resource transfers to these countries from the industrial countries.

Appropriate adjustment for the indebted countries requires that growth is ensured as a major target. The problem is that little is known about the appropriate design of adjustment policies. A logical implication is that whatever else the Fund does, it must be actively engaged in working out such program designs.

I agree fully with Mr. de Groote about the need for an allocation of SDRs to supplement the reserves of indebted countries. An SDR allocation does not have to involve the old "link" proposals whereby the allocation would be redistributed as an overdraft facility to the developing countries in relation to their reserve needs. Mr. de Groote's proposal for the conditional relending of SDRs also encountered problems because it was conditional. Nevertheless, similar proposals can be formulated and the best among them chosen if the logic of reserve supplementation is accepted. That logic should be particularly appealing to those who believe that a solution to the debt problem should be market based, because the level of reserves is a major determinant of lending by the commercial banks.

Mr. Grosche made the following statement:

It is clear from the discussion on the world economic outlook that the debt problem remains with us despite the progress achieved since 1982. The challenge is clearly described by the staff: how can the Fund assist in catalyzing both renewed flows of foreign and domestic savings to indebted countries in sufficient amounts to support growth and to bring the debt burden into a sustainable relationship with exports? In discussing financing for debt-ridden countries, it is appropriate to differentiate between those countries which are mainly indebted to official creditors and those which are mainly indebted to banks.

The most appropriate way to secure an adequate inflow of external resources remains the implementation of economic policies that restore the confidence of investors, particularly the confidence of the country's own citizens. In the face of the severe difficulties in several middle-income debtor nations, the vast potential of possible financing stemming from a repatriation of capital flight cannot be overlooked. The fact is, there is a considerable amount of private capital in the world searching for investment opportunities. At the same time there are many borrowers, including official borrowers from industrial countries, who compete for these resources. The highly indebted middle-income developing countries have to face up to this competition--which certainly could be less severe if industrial countries would reduce foreign borrowing--and they have to work even harder to re-establish their capability to tap the international capital markets. Otherwise, they will not be in a position to get the capital inflows they need to make full use of their growth opportunities.

What is the Fund's role? What can the Fund do to assist member countries in obtaining an adequate cash flow? First of all, the main task for the Fund remains to assist countries in introducing the necessary macroeconomic and structural policy reforms. Indeed, the Fund should concentrate on the development and implementation of good adjustment programs. After having determined its own financial contribution, depending on the strength of the adjustment effort, the Fund has to identify the remaining gaps and has to obtain financing assurances for filling these gaps. But the Fund should refrain from playing an active part in the negotiations between the banks and debtors, and the Fund should refrain from suggesting additional "dishes" for the menu of financing options. It is up to the banks and the debtor countries to initiate and agree on how to integrate and possibly extend the options in financing packages, including ways of sharing the discount on countries' debt in secondary markets as well as other techniques that work to reduce the debt burden. I fully agree with Mr. Dallara that such schemes have to be market based, clearly voluntary, and handled in a case-by-case fashion.

Despite what I have said on the role of the Fund, it is tempting to offer still another scheme to help reduce the interest burden without creating too many moral hazard problems. Like Mr. de Groote, I believe that the interest burden is the real issue, not the outstanding capital. For example, the recent Mexican debt-bond exchange scheme could easily be modified; in my plan the debtor country would also buy zero coupon bonds for collateral but with longer maturities, which would make them less costly. More important, however, the country would not offer an up-front discount on the value of its old debt. Instead, it would contract for a below-market fixed rate that would make its cash flow more predictable. The difference between the below-market rate and the London interbank offered rate (LIBOR) would be capitalized and could be negotiated later, if the country implements fully its adjustment program and pays the reduced interest on time. Most important, the better the performance, the higher the price for the country's rescheduled claims on the secondary market and the lower the interest rate on new bonds that the country may wish to issue in order to get fresh money. But again, it should be stressed that it is not the role of the Fund or creditor governments to bring their influence to bear on the parties directly involved in the negotiation of financing packages. Moreover, it is clearly not the task of governments or official institutions to provide money for the menu of options. This would imply a bailing out of the banks. It is, however, appropriate and necessary that the governments of industrial countries set up an adaptable framework for bank supervision and tax regulation in order to facilitate the operation of the menu of options; the Federal Republic of Germany has done so in the past and will continue to do so.

In suggesting a blending of new financing with techniques that, in effect, work to reduce debt, the staff does not, I assume, have in mind the establishment of an international debt facility that would purchase debt at a discount and then write down its contractual value, hence providing debt relief. The establishment of a debt facility would likely lead to a large transfer of risk from commercial banks to governments or multilateral institutions. I cannot imagine that my authorities would lend their support to such an idea. It is politically difficult to impose on taxpayers in industrial countries an additional burden before debtor countries have found ways to mobilize the foreign assets of their own well-to-do citizens or at least have subjected them to reasonable property and income taxes. Moreover, I fully share Mr. Posthumus's and Mr. Cassell's view that the discussion about an international debt facility or other general schemes is a disservice to the debt strategy, because it discourages banks and countries from facing up to reality and thereby slows down the process of resolving the debt problem. Why should banks give in today when they can expect official institutions to help them out sometime in the future?

As regards the critical mass of financing assurances from commercial banks, I certainly recognize that delays in bank financing can jeopardize the timely and effective implementation of adjustment programs. However, outright approval of Fund arrangements in the absence of reasonable assurances that financing gaps will be filled would entail considerable risks, notably the risk that the program could derail later if the expected financing should not materialize. Compared with approval in principle, a more flexible approach does not necessarily provide more protection to the eventual success of adjustment programs. Here, another risk is that undue flexibility in the Fund's policy of financing assurances could give rise to moral hazard problems. In particular, such flexibility could work as a disincentive for commercial banks to seek early financing agreements, especially if the Fund arrangement provides for the resumption of debt service payments to the banks. In some exceptional cases, Mr. Posthumus's approach may prove to be successful; in others, the use of the Fund's authority under Article VIII may have to be demonstrated.

In sum, my authorities see no alternative to the case-by-case, market-based approach to the debt issue. However, they would like to see more and faster action from both debtor countries and the banks. The Fund should provide clear signals regarding what it expects from debtors and creditors. In my view, the Fund's catalytic role has to do more with policy advice than higher access to its resources, although I would not dismiss the importance of the Fund's financing.

Finally, with respect to the Paris Club, my authorities favor continuing its basic approach, looking for improvements where appropriate. For example, pledges for multiyear reschedulings with specification on an annual basis could be used more often. With regard to Paris Club policies vis-à-vis the poorest debtor countries and Mr. Cassell's suggestion, it is difficult for Germany to introduce more concessionality through interest rate concessions on rescheduled commercial debt. But Germany has already substituted grants for credits and, in fulfilling UN Resolution 165, it has already forgiven all of its aid loans to the 24 poorest countries.

Mr. Sengupta observed that in Mr. Grosche's debt restructuring plan, offering an interest rate below LIBOR clearly implied a discount on the value of the debt. How would the below-market fixed rate be determined?

Mr. Grosche remarked that the banks might be willing to restructure the outstanding debt in such a way that no discount would be granted on the outstanding capital. They would, however, fix an interest rate below the market rate, would agree to capitalize the difference between the fixed rate and the market rate, and would postpone negotiations on the capitalized interest depending on the strength of the adjustment and the country's record of servicing the reduced interest burden. If the country was successful in implementing its economic program, a reward for adjustment might be negotiated to alleviate the accumulated interest obligation. If, however, the country was not successful in meeting payments on the remaining interest burden, then the prior situation would obtain. The most important aspect of such a scheme would be that success in servicing the reduced interest would keep secondary market prices on the country's claims at a high level, and the higher the price, the lower the effective interest rate and the greater the chances for the country to issue bonds on the secondary market at a relatively low interest rate, which would help it to obtain fresh money.

Mr. Zecchini made the following statement:

The staff paper on the debt strategy is a good summary of the status of our approach to the debt problem and, if compared with the previous staff paper on the subject, does not represent an advance in terms of innovations in the instruments of our strategy but rather in terms of a pragmatic recognition of what is realistic and feasible at this juncture. In this light, the approach outlined by the staff is not the end of the road but another leg in a long journey whose final goal is to restore normal debtor-creditor relationships based on a balance between the stock of debt and the debt-servicing capacity of the debtors.

It is evident that our approach to the debt problem was effective in the early stages of the crisis but has not been fully adequate in the later stages. In this respect, it is disappointing to see that in 1987 for the second year in a row, the net exposure of the nonofficial lenders vis-à-vis developing countries did not increase while official net lending continued to rise. Furthermore, new signs of tension have emerged in the international payments system as debtor countries are resorting more frequently to a larger accumulation of arrears to finance their balance of payments gaps. This practice is also inconsistent with the pursuit of further adjustment.

My authorities agree with the Chairman's assessment that the debt situation remains serious and requires a renewed spirit of cooperation among all parties in order to progress toward a solution. In this light, they are in favor of strengthening the current approach along the lines of market-based options, tailored to the specific needs of each debtor country and supported by a strong catalytic role for the Fund. In this respect, they do not think that a uniform, centralized approach to resolving debt difficulties would be appropriate, nor do they believe that the key to the solution of the debt problem lies in the search for increasing sophistication in financial engineering for these countries. In contrast, a framework has to be established in which adjustment of external and internal imbalances can coexist with a faster pace of economic growth.

In this context, the catalytic role of the Fund has to be enhanced, as it is fundamental for the success of our approach to the debt problem. This role should be based on two pillars, namely, more extensive support to the debtor country in the design, implementation, and monitoring of multiyear programs aimed at correcting imbalances; and, more effective assistance to the member in negotiating with all of its creditors for the financing needed to support the program on terms that are consistent with the member's debt-servicing capacity.

In this latter respect, the menu of options has evolved substantially in the last two years, and through the cooperative attitude of the Fund, it can continue to evolve in the near future to serve the best interest of all parties. The Fund itself has provided a new option through the enhancement of the structural adjustment facility, and can further enlarge the menu of options by establishing external contingency mechanisms, revising the extended Fund facility, and extending the scope of adjustment programs to cover structural reforms. With regard to the Fund's role in gaining assurances for financial relief from creditors in the framework of a Fund-supported program, a clarification of this aspect, as described on page 9 of EBS/88/55, might be useful. Finally, my authorities are ready to consider positively the option under which official creditors would pledge to provide medium-term support to multiyear programs under the extended Fund or enhanced structural adjustment facilities through debt rescheduling while leaving the definition of terms to be determined annually.

Mr. Yang made the following statement:

It is widely recognized that the resolution of the debt problem requires persistent efforts by debtor countries to adjust their economies, a favorable international environment, and adequate external financial support. Obviously, not one of these conditions can be dispensed with. Since the outbreak of the debt crisis in 1982, the debtor countries have undertaken considerable measures to adjust their economies. These adjustment efforts have significantly contributed to the strengthening of the international banking system. Meanwhile, however, the supportive global environment and adequate external financing envisaged in the debt strategy have not yet materialized. Consequently, the net resource transfer from debtor countries to creditor countries has remained at an unsustainable level, which has resulted in stalled economic growth and widespread poverty in large sections of the population in the majority of indebted countries. In these circumstances, there is not much hope for an improvement in the global environment and a resumption of commercial lending.

Moreover, the debt service burden of the debtor countries has become acute. Faced with inadequate external financing, the debtor countries' governments have had to buy foreign currency from their export sector to service their debt. A heavy debt service burden, therefore, necessarily leads to a rising budget deficit which, in turn, gives rise to high inflation as governments resort to the inflation tax to cover the deficit. Because of the unbearable debt burden, many countries have suffered from mounting budget deficits, high inflation, a decline in real wages and, most seriously, the loss of public confidence in their stabilization programs. It is, therefore, fair to say that for many countries, slippages in the implementation of stabilization programs are closely related to excessive debt servicing. Obviously, the practice of servicing debt at the expense of economic growth and economic stabilization cannot continue indefinitely. This fact perhaps explains why some debtor countries have opted for a unilateral moratorium. Such action, however, carries with it a heavy cost for both debtors and creditors. To maintain constructive cooperation between debtors and creditors, it is imperative to find ways and means to reduce debt service burdens to sustainable levels that will allow the debtors' economies to grow at an adequate rate so that they are able to gradually grow out of debt.

To achieve this goal, significant steps have been taken in assisting the low-income indebted countries, including concessional loans and grants from a wide range of countries and international institutions. The establishment of the Fund's structural adjustment facility two years ago has also been instrumental in supporting the adjustment efforts of low-income countries. A new concessional lending facility--the Fund's enhanced structural adjustment facility--has added considerably to the resources available for assisting the poorest countries. And, I very much appreciate Mr. Cassell's remarks this morning regarding further financial assistance to the low-income countries.

With regard to middle-income indebted countries, many financing options have been put forth under the menu approach to compensate for the lack of new commercial lending. A common feature of these financing options is the recognition of the difference between the contractual value of the debt and its current value in the secondary markets. Based on market developments, voluntary debt reduction has been freely granted by creditors through negotiations with debtors in exchange for assurances regarding the repayment of the remaining debt. This approach is beneficial to both debtors and creditors, and, consequently, there is great potential for further pursuit of debt relief schemes through expansion of the menu of options. It is hoped that, based on experience with the recent Mexican debt-bond exchange, some other imaginative mechanisms will subsequently emerge so as to reduce countries' debt burdens to a sustainable level.

Another approach worthy of consideration is the adjustment of each country's debt servicing to its repayment capacity, consistent with adequate economic growth. This adjustment can be achieved by establishing mechanisms that link debt repayments to developments beyond the control of the debtor countries. Although experience with contingency schemes is more limited than that with debt conversion schemes, contingency mechanisms are potentially useful, and further exploration of them may be worthwhile.

Finally, this chair supports the initiatives to enhance the Fund's lending instruments, particularly the extended Fund facility, to improve the design of adjustment programs with the addition of some form of contingency financing mechanism, and to streamline the implementation of conditionality. My authorities believe that these initiatives will significantly strengthen the Fund's role in resolving the debt problem.

While it is certainly right for the Fund to be prudent and tactful in respect of negotiations on financing arrangements for member countries, it would hardly be advisable for the Fund to reduce its involvement in debt management at a time when the evolution of the debt strategy is at a critical stage.

Mr. Santos made the following statement:

I am in broad agreement with the staff's general assessment of the debt strategy. So far, the positive developments in the strategy's evolution include a significant degree of external adjustment undertaken by many debtor countries, as well as the strengthening of the international banking system. Progress toward balance of payments viability, however, has been evident in only a few debtor countries, and despite the improved, credible policies that have been adopted and implemented by some of these countries under Fund-supported adjustment programs, most of them have not been able to attract new bank credit to support their growth-oriented efforts. The ability of most of these countries to cope with their debt service burdens has thus become elusive, and the restoration of normal relations with creditors appears more remote than ever.

Earlier Board discussions on the debt situation have laid out the main reasons for the partial success in these areas, and

I do not wish to reiterate them. However, let me underscore an important weakness of the current debt strategy, namely, the reluctance of banks to increase their exposure in the indebted countries, despite attempts by the Fund to catalyze external financial resources by encouraging both debtors and creditors to intensify their cooperative efforts. Instead, a number of financing techniques have emerged that were not envisaged a few years ago. This development reflects the banks' failure to respond adequately to the international community's expectations at a time when the foundations of the international trade and payments system is threatened by the debt problem. In the absence of a significant positive move by the banks to support the debt strategy, new avenues that take into account the debtors' ability to pay need to be explored.

As for the issues raised in the main staff paper, I agree with the staff on the need for different approaches to address the particular concerns of different groups of debtor countries. In this context, I recognize the steps that have been taken, especially during the past 12 months, to alleviate the debt burden of the low-income countries. These steps are well described in Section II of the staff paper. It is clear that if the growth-oriented adjustment efforts of these countries to overcome their structural weaknesses are to succeed, they need to be supported with adequate financial resources on concessional terms. In this context, I fully share Mr. Cassell's view that any lasting solution to the debt problem of the poorest countries should involve concessional interest rates in Paris Club reschedulings and the conversion of debt into grants.

On the evolution of the menu approach, during the previous discussion on the debt strategy, this chair stated that the development of many financing options "have the merit of helping to widen the scope for strengthening the current debt strategy." To be effective, they should be based on financial market developments and voluntary negotiations between debtors and creditors and should allow the indebted countries to share in the market discount on their debt. I note that the banks are developing ways of burden sharing in addition to expanding the menu of options to make participation in financing packages more attractive. For these innovations to succeed, it is hoped that creditor governments would provide the necessary support by further adapting and improving the regulatory and tax environment in which banks operate.

Finally, on the catalytic role of the Fund, it is disappointing to note that the Fund has not always been successful in helping to mobilize adequate external finance to support members' adjustment programs. I recognize that the Fund has made efforts to catalyze external financial resources and that the exercise of its catalytic function is changing as circumstances change.

In view of these circumstances, the Fund has taken actions that are designed to help indebted countries to adopt and implement growth-oriented programs. The establishment of the enhanced structural adjustment facility and the revitalization of the extended Fund facility are welcome, as they will enable the Fund to assist member countries more effectively. The integration of external contingency mechanisms in Fund-supported programs will also enhance the prospects for successful adjustment and is therefore likely to mobilize further financial involvement by other creditors.

Mr. Salehkhou made the following statement:

The staff paper on the debt situation, although concise and clear, does not relieve the concerns I expressed during our seminar on the debt strategy, or for that matter, during other subject-related discussions. I was indeed struck by the almost neutral tone and descriptive nature of the paper prepared for the seminar on the debt strategy, which left the Fund in the position of an observer rather than of an institution supposed to play an active, central role in the debt strategy.

The reasons for this shift are obvious. After substantial Fund intervention at the onset of the debt crisis, the policies pushed by major industrial countries and subsequently implemented under the guise of the Fund's catalytic role have undermined this institution's effectiveness in dealing with a host of complex, multifaceted problems. These policies have tended, and continue to tend to increase conditionality, have sharply reduced effective access to Fund resources, have discouraged use of the extended Fund facility, and have dismantled the compensatory financing facility. This orientation, coupled with the launching of the new debt strategy in 1985, was presumably intended to conserve Fund resources, thus rendering the Ninth Quota Review technically unnecessary. Other restrictive policies were put into place, including a ban on a new SDR allocation.

Parallel to these misguided and ill-timed decisions, the banking community in turn was expected to increase its exposure in selected heavily indebted countries so as to enable them to promote growth and grow out of their debts. It is well known, and the staff paper makes it abundantly clear, that this has not happened. The reasons for this can be argued endlessly, but in my view they are largely to be found in the withdrawal of the Fund's financial support at appropriate levels so as to promote the institution's catalytic role. Limiting the role of the Fund to mainly advising the debtor countries and helping them to devise adjustment programs did not, and will not, attract the necessary understanding on the part of commercial banks.

Among the debtors, adjustment fatigue is taking its toll. Debtors are asked to implement strong adjustment and structural policies in the vain hope of someday regaining their creditworthiness, but financial gaps remain unfilled and thus often contribute to the failure of well-designed and, for the most part, well-implemented programs. More often, abrupt changes in exogenous factors brought about by sudden shifts in industrial country policies--for example, exchange and interest rate policies--shatter even the best-designed programs. And if the Board's frequent recent discussions on external contingency mechanisms are any indication, it is doubtful that the meager access and complicated operational features proposed for such mechanisms will change the situation for all practical purposes.

Official creditors, although more helpful than commercial bank creditors, have stuck to rigid rules, and apart from more generous rescheduling terms for the lowest-income countries, these rules have amounted to muddling through and to protracted yearly negotiations with individual creditors. Another factor hampering progress is the strict rule relating to the cut-off date, which runs the risk over time of making the rescheduling process almost meaningless.

In view of these difficult circumstances, I wonder how debtor countries can resolve the central problem of catalyzing "both a renewed inflow of foreign and a sufficiency of domestic savings to support domestic growth and to bring debt service burdens into a sustainable relationship with export potential," as the staff has hoped. I doubt that the application of fancy labels such as "strategy," "menu approach," and now "market-based approaches," among numerous others, or even changing the relationship between "creditor and debtor" to one of "lender and borrower" would positively contribute to a satisfactory solution of the debt problem. These appellations, if void of substantive content, will further discourage both debtors and creditors. I continue to wonder how long creditors can avoid consideration of some schemes of debt forgiveness. I will therefore not comment on the technicalities of the market-based approaches, which have not been successful in containing the debt problem even in recent applications where conditions were exceptionally favorable for their success.

As to the prospects for the low-income countries, actions by the Fund and the World Bank, including the overdue and anxiously awaited enhancement of the structural adjustment facility, are steps in the right direction. These actions should be complemented not only by exceptional grace periods and maturities granted by official creditors, but also, and more important, by more generalized debt forgiveness. Frankly, I am not so sure that these options, even if made available--which is not likely--would assure sufficient resources to revive growth in these countries. Indeed in most cases, despite harsh adjustment measures, the resources have been, and will continue to be, mainly used to service the volume of ever-increasing debt.

As for the middle-income countries, their situation is more complex, and I completely agree with the staff that "debtors have questioned whether commercial banks are not slipping into a psychology of debt collection and away from constructive support." The support of commercial banks for this category of debtors is obviously crucial if these countries are to promote growth for which they generally have good economic potential. Unfortunately, however, this growth potential is frozen, and like the staff, I wonder if "the difficulty of sustaining, politically, the momentum of domestic reform is all too real and some countries could come to see arrears as the only timely way of obtaining new finance from banks." Knowing too well the disruptions that such an attitude could lead to in countries generally open to world trade, I fail to understand the logic of the position of private, as well as official, creditors in not sufficiently helping this category of countries, in view of their potential to grow out of their debt.

On the role of the Fund, while agreeing with the broad outline in the main staff paper, I urge the major industrial countries to give this role its full meaning if we are to "encourage both debtors and creditors to remain on the cooperative course." The industrial countries have, instead, put more emphasis on "encouraging" debtor countries to adopt and implement sufficiently strong and comprehensive economic policies in order to restore growth and credibility, which remain elusive.

It is disconcerting that our discussions on revitalizing the extended Fund facility, on the review of the compensatory financing facility, and on the creation of external contingency mechanisms have not yet led to a strong consensus in the Board. To this can be added the decision to postpone the Ninth Quota Review and, in light of the prevailing uncertainties, its unlikely conclusion next year, as well as the unresolved question of an SDR allocation. It is even more disconcerting to note the increasingly disproportionate emphasis put on the revolving character of the Fund's resources rather than on the main objectives of the institution. If this continues, I am not sure how the Fund would be in a position to play even the catalytic, let alone the central, role envisaged for it in the debt strategy.

The industrial countries may wish to review their positions in a more comprehensive manner if a substantive, meaningful content is to be given to the cooperative role of this institution and if we are to avoid a reputation in history as petty financiers who lacked strategic ability as well vision.

Mr. Archibong made the following statement:

During our recent discussion on issues in the debt strategy, this chair highlighted the weaknesses of the existing strategy and suggested some ways of strengthening it, which I do not intend to repeat here. The current debt situation indicates that for most of the heavily indebted countries, external debt servicing continues to deepen in its severity and threatens to undermine the resumption of economic recovery in these countries. My authorities remain skeptical about the effectiveness of the current debt strategy, which since its implementation in 1982 appears to offer limited hope for a durable solution. The staff papers indicate that progress has been painfully slow, and in this respect, this chair lends full support to any positive effort to strengthen the existing debt strategy. Such strengthening would necessarily include improvements and initiatives that go beyond the traditional rescheduling of principal payments falling due during a normal consolidation period of one year or so.

At the outset, my authorities wish to reaffirm their willingness to continue implementing strong and comprehensive adjustment programs in order to reduce internal and external imbalances while removing structural bottlenecks. Such efforts are necessary to create a financial and economic environment conducive to the resumption of sustainable economic growth and the normalization of relations with creditors. These efforts, however, would need to be strongly supported by the international community through appropriate macroeconomic policies in industrial countries aimed at stimulating and sustaining a growing world economy, and, at the same time, adequate levels of financing would need to be provided to debtor countries on highly concessional terms. It should be recognized that what the staff has characterized as a "stop-go" pattern of policy implementation in a number of debtor countries is merely a manifestation of their authorities' concerns regarding the unduly high cost of adjustment in the face of a serious shortage of financial resources. As a consequence, adjustment fatigue has begun to set in and threatens to undermine the sustainability of debtors' adjustment efforts.

On the specific elements of the debt strategy and particularly those initiatives that are designed to alleviate the debt problem of the low-income countries, my authorities welcome the establishment of the enhanced structural adjustment facility as a more appropriate source of financing for the adjustment needs of these countries. The facility should play a pivotal role in all financing packages for those countries experiencing protracted debt problems as well as difficulties in meeting their obligations to the Fund. The total debt of these countries must be reduced, and serious efforts should be made to ameliorate the cost of shifting the remainder of outstanding debt to a more favorable term structure. In this connection, other initiatives under the auspices of the World Bank, such as the facility for debt distressed African countries, deserve serious consideration.

In the meantime, rescheduling arrangements should remain an important feature of the debt strategy. Therefore, we must encourage all parties concerned to be innovative and cooperative in this respect. My authorities welcome some desirable changes that have already been implemented in reschedulings, including longer grace and maturity periods and their linkage with Fund arrangements other than traditional stand-by arrangements. However, it is regrettable that some proposals to further ameliorate the costs of rescheduling have not yet received a favorable response. The proposal of the U.K. Chancellor of the Exchequer is strongly commended by my authorities as a possible positive contribution to easing the debt problem of the low-income countries. Central to this proposal is the extension of subsidies to market-related interest rates in Paris Club reschedulings for these countries. There can be no doubt that immediate, crucial assistance is needed chiefly in the form of interest rate reductions and the conversion of aid loans to grants. And, while my authorities appreciate the legal and legislative impediments that hinder the acceptance of concessional interest rates by some creditors, they strongly urge those countries that have not yet supported the U.K. proposal to do so, and--if need be--to introduce financing innovations without offsetting any assistance given in this regard by reducing their bilateral aid.

It should be noted that rescheduling costs such as service and interest charges have actually increased the debt burden. For sub-Saharan Africa, it is estimated that charges arising from external debt reschedulings add some $1 billion annually to the total debt burden. Thus, the debt relief provided through longer maturities and grace periods may be more than wiped out by subsequent higher debt burdens resulting from a rise in charges. To enhance effective debt management, favorable rescheduling terms, among other things, must be part of the package.

The rescheduling modalities in respect of suppliers' credit also deserve attention. It is important that disruptions in suppliers' credit be kept to a minimum in order to maintain the flow of capital and intermediate goods.

As for commercial debt rescheduling under the London Club, developments have been somewhat more diverse than those relating to official debt rescheduling. However, improvements have generally fallen short of expectations. Banks remain relatively reluctant to increase their foreign exposure, and only a few debtor countries have managed to normalize their relations with the banks. As for financing techniques, the real test of viability would be whether they provide "light at the end of the tunnel." Obviously, viability has been difficult to achieve even where new money packages have been arranged in connection with Fund-supported adjustment programs, thus revealing a serious weakness of the strategy.

In this connection, the revitalization of the extended Fund facility raises hopes in two respects. First, it could provide the Fund with the capacity to more effectively enhance the financeability of indebted countries' adjustment programs. Second, it offers an implicit recognition of a longer time horizon for resolving the debt problem. Therefore, medium-term adjustment programs of three to four years' duration would appear to be suitable for laying the basis for growing out of debt.

A major problem of the current system of debt relief is the limitation of the debt consolidation period to not longer than one year. A way must be found to avoid the interminable cycle of annual reschedulings, which is costly to both debtors and creditors and also impedes forward planning.

As regards new financing techniques, the staff has clearly analyzed their consequences for all participants--debtors, creditors, and regulators. The most appealing initiatives are those that seek to reduce total indebtedness while ameliorating the debt-servicing burden. In that connection, debt-equity conversions, which might be viable for some countries, such as Chile, remain problematic for others. The Mexican debt-bond exchange, which resulted in a reduction of total debt by about $1.1 billion, represents a significant development. Although most of the countries in sub-Saharan Africa may not be able to participate in some financing schemes because of the nature of their debt, a few of these arrangements, especially debt conversions, could probably be tailored to suit a number of countries if, as Mr. de Groote has noted, some reserves could be accumulated for that purpose.

Finally, my authorities agree with the views expressed by the Institute of International Finance that the management of the debt problem has reached a critical stage where urgent action is required on an additional SDR allocation amounting to SDR 21.4 billion per annum during calendar years 1988 and 1989. An allocation of this magnitude is considered necessary in part for use as collateral for new money flows to the benefit of both debtors and creditors. Therefore, in addition to further improvements in rescheduling schemes and a global economic situation that is optimal in its capacity to provide the necessary markets for developing countries to increase their exports under conditions of lower real interest rates, an allocation of SDRs must, in the current circumstances, be an integral part of an effective debt strategy. I commend Mr. de Groote for his imaginative proposal, which concurs with the Institute's position on an

SDR allocation. My authorities strongly urge the Board to seize the opportunity to utilize this instrument to help ameliorate the growing debt problem at this critical time. By so doing, the Board would demonstrate clearly to the international financial community that strong actions are urgently required by all participants to confront the difficult debt situation.

Mr. Othman made the following statement:

During the recent Board seminar on the debt situation, this chair expressed its views on the various issues relating to the debt problem and the current debt strategy. It was noted then that as, for the most part, the necessary conditions for the debt strategy's success did not materialize, the strategy has not worked as well as had initially been thought possible. While the strategy has been successful in averting the threat of instability and disruption in the international financial system and in somewhat containing the spread of adverse effects to creditworthy countries, it has been less successful by far in reviving economic growth in debtor countries and restoring normal creditor-debtor relations.

The unsatisfactory performance of the debt strategy in respect of the latter two objectives has often been attributed to uneven policy implementation in debtor countries, which has, in turn, retarded the renewal of confidence among investors. However, policy implementation clearly cannot be viewed in isolation from the external environment, including the availablity of external financing. In retrospect, it is difficult to see how policy implementation in debtor countries could have been more even or how policy implementation alone could have sparked a renewal of confidence among creditors. For, on the one hand, the external environment was hardly conducive to an export- and growth-oriented adjustment strategy in these countries, as is manifested by the adverse evolution of real interest rates, terms of trade, and access of debtor country exports to creditor country markets, as well as the persistence of large internal and external imbalances in and among the major industrial countries and the attendant uncertainties in respect of interest rate developments. On the other hand, external financial flows to debtor countries receded drastically, and financing packages became increasingly more difficult to assemble.

There can be little doubt that these adverse developments have seriously impaired the developing countries' ability to persevere in their adjustment efforts and to grow out of their debt. In fact, over the past four years, real GDP growth in countries experiencing debt-servicing difficulties averaged about 3 percent per annum, which, in view of the adverse external environment, was hardly sufficient to maintain adequate levels of domestic absorption while effecting the needed external adjustment. It is indeed remarkable under the circumstances that, over the same period, the large, heavily indebted middle-income countries have been able to achieve a combined improvement in their current account of nearly 8 percent of GDP in real terms. It should be kept in mind, however, that with the virtual cessation of new money flows into these countries, this improvement was obtained against the backdrop of a decline in investment. The implications of this adjustment path for the sustainability of future adjustment efforts can be serious. To the extent that future consumption will decline as a result of the decline in investment, the prospects for public support of these efforts will be that much weaker. Such developments, which have been experienced in many of the heavily indebted countries, have undoubtedly had serious implications for the ability, both actual and perceived, of these countries to service their foreign debt obligations, and, hence, for their access to international financial markets.

With the strengthening in the position of commercial banks through provisioning and other means, their resistance to requests for increased exposure, particularly in countries experiencing debt-servicing difficulties, has intensified. This development seems to have been a major motivating factor behind the evolution of a number of market-based financing techniques and approaches to reduce or transform existing debt. In a sense the evolution of these adaptations to the debt strategy has reflected a spontaneous gravitation toward a market-based apportioning of the burden of adjustment between debtor countries and commercial banks, thereby reflecting greater realism on the part of both parties. However, at this stage, these supplementary approaches to the debt strategy remain complex, and their contribution to the normalization of debtor-creditor relations remains limited. It is hoped that as more experience is gained with these approaches and as more options are added to the menu, their potential for contributing to a stabilization of, and possibly a reduction in, the debt burden will be enhanced. Indeed, recent additions to the menu have confirmed a tendency toward negotiated instruments that enable indebted countries to share in the secondary market discount on their debts. The recent debt-bond exchange by Mexico, although only partially successful, is an example of such instruments. While its applicability to other countries is limited by the need for freely available external resources, the Mexican scheme represents a significant step in debt management and could spawn further adaptations in the debt strategy. The experience with Mexico's debt-bond exchange serves perhaps to confirm the view that there is no single, or simple, solution to the debt problem. Of course, the hope is that various adaptations to the current strategy will combine to significantly, albeit gradually, contribute to a resolution of the debt problem--a task that continues to require a determined cooperative effort on the part of debtors, creditors, and multilateral institutions.

For its part, the Fund will continue to have an important role to play in designing, promoting, and supporting growth-oriented adjustment programs in a manner that is conducive to the success of the cooperative effort under the current debt strategy. The exercise of this role has evolved with the changing circumstances and has led in the recent past to a number of welcome developments. These include the enhancement of the structural adjustment facility in response to the exceptional difficulties of low-income countries, as well as the ongoing efforts to revitalize the extended Fund facility and adapt Fund facilities and procedures in response to the challenges posed by the current debt situation. It is hoped that these adaptations will enhance the Fund's catalytic role. While other sources of external financing will continue to play the central role in financing the balance of payments of debtor countries, it is also important that the Fund enhance its ability and willingness to make its own financial resources available in support of growth-oriented adjustment in those countries. It is perhaps worthwhile to emphasize that in helping debtor countries to grow out of their debt, the Fund thereby also helps to restore balance in the world economy as a whole. The debt problem is not a problem of the debtors alone; it is an enormous burden on the world economy.

Finally, on the stand-by arrangement with Egypt, which was referred to this morning, I fully agree with the Chairman's remark that approval of Egypt's program was based on the same guidelines that govern the Fund's policies in general. Indeed, approval was granted only after financing assurances were obtained from creditors. It is true that the program subsequently faced some difficulties. But this is not unusual. If all programs that went off track were to be considered as unsustainable from the outset, then the list of unsustainable Fund-supported programs would be quite long.

It is important to dispel any wrong impressions about Egypt's current relations with the Fund that may have been left by the remarks made this morning. As Directors know, intensive discussions are currently taking place between Egypt and the Fund on how to maintain and strengthen Egypt's adjustment efforts. These discussions are taking place in good faith and in a spirit of cooperation. Indeed, the authorities are hopeful that these discussions will soon succeed in achieving their desired objective.

Mr. Dallara remarked that he had considerable sympathy for some of the notions expressed by Mr. Massé, Mr. Posthumus, Mr. Ovi, Mr. Grosche, and Mr. Rye concerning the role of the Fund, particularly with respect to its financing position. Like Mr. Ovi, he had also detected a potentially more active role for the Fund than he would be comfortable with in the statement on page 8 of the main staff paper that the Fund might assist countries in negotiating with key creditors. However, he was likewise concerned about the withdrawal or a reduction of the Fund's role.

In the current phase of the debt strategy, if the Fund was too reticent in its relations with debtors and creditors, it was possible that other intermediaries might assume a more active role, Mr. Dallara observed. However, there was no other multilateral institution in a position to assume the role that the Fund had played in the debt strategy in recent years. Moreover, the role that officials in creditor governments could themselves play was inherently limited, although useful. Inevitably, multilateral leadership was critical to develop financing packages in support of debtors' adjustment efforts, since the problem was a multilateral one. In that regard, he recalled that Mr. Zecchini had suggested that perhaps the Latin American debt problem was primarily the concern of U.S. creditors. However, the facts were clear: commercial bank lending in the 1970s and 1980s to Latin America was not exclusively by U.S. banks; indeed, U.S. commercial bank exposure was roughly comparable to European commercial bank exposure and somewhat greater than that of Japanese banks. In that sense, the role of multilateral agencies in facilitating and guiding the cooperative efforts of debtors and creditors was an important one.

While the concern of some Directors about Fund intervention in negotiations between creditors and debtors on financing packages was striking, so was management's point that the Executive Board was increasingly insistent upon clear financing assurances prior to approving the disbursement of Fund resources, Mr. Dallara continued. In that sense, the views of the Board were not entirely consistent; if it insisted that management should obtain clear financing assurances before putting programs to it, inevitably some degree of activism was required to accomplish that objective. If the Fund became too passive, it might have to proceed without adequate financing assurances or face the possible emergence of a more confrontational approach on the part of indebted member countries based on balance of payments financing through the accumulation of arrears. Such developments could pose serious threats to the system as a whole.

The problem of balance of payments financing through the accumulation of arrears would be addressed in the context of the Board's discussion on the Fund's jurisdiction under Article VIII, Section 2(b), Mr. Dallara remarked. However, if a noninterventionist role was being suggested for the Fund, it had to be noted that there was perhaps no more fundamental form of intervention than the use of that provision. Such intervention by the Fund in relations between creditors and debtors would require considerable further reflection and demonstrated the complexity of its catalytic role.

The Executive Directors agreed to continue their discussion on the debt strategy on the following morning.

2. PEOPLE'S REPUBLIC OF MOZAMBIQUE - STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on Mozambique's request for the second annual arrangement under the three-year structural adjustment arrangement approved on June 8, 1987 (EBS/88/40, 2/25/88), together with a policy framework paper (EBD/88/68, 2/25/88). They also had before them a statement by the Managing Director, which reads as follows:

The Managing Director made the following statement:

> For the information of Executive Directors, the following is the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and the International Development Association in their March 22, 1988 discussion in Committee of the Whole of a paper entitled "Mozambique: Policy Framework Paper."
>
> The Committee of the Whole discussed the policy framework paper for Mozambique and commended the Government for its timely and effective implementation of the first-year program. It was acknowledged that the liberalization of pricing, trade, and distribution marked a significant reorientation of past economic policies. In addition, it was noted that the initial impact on growth had been most promising, although the recovery was still very fragile and sustainable growth had not yet been achieved. Speakers noted the commitment and the courage of the Government in implementing the program under difficult circumstances, especially the ongoing security problem and the severe deficiency of skilled manpower.
>
> The Executive Directors commended the policy framework paper for presenting a sober and realistic assessment of the medium-term economic prospects for Mozambique. They noted that the pace of the adjustment process was affected by the constraints under which the Government was operating, but emphasized the importance of maintaining the momentum of reform. While considerable progress had indeed been made in both the private and public sectors, these were still only the first steps in removing the serious economic distortions that had accumulated over many years, and some speakers felt there might even be some scope for accelerating the pace of reform. Speakers noted the importance of deregulation in the production and distribution spheres, emphasized the role of the Government's current enterprise

restructuring program, and stressed the need for continuing movement on the exchange rate and related trade measures. In this connection, some speakers emphasized the potential value of increased foreign investment and its participation in the restructuring process, and the role that divestiture could play in reducing the burden of uneconomic enterprises on the budget and the banking system. The pace of adjustment and sustainability of growth are also likely to be influenced by the progress made in broadening Mozambique's now very limited base of skilled human resources.

The Executive Directors were concerned about the social impact of the reform program, notably the effect on the urban population of the impending increase in prices of rationed goods and the short-term impact on unemployment. While these were seen as necessary in restructuring the economy, the need to monitor carefully the developing situation was stressed. The buffering measures were welcomed by several speakers and seen as essential to sustaining the program.

The Executive Directors expressed considerable concern regarding the ongoing security situation and its impact on the environment necessary to carry forward a comprehensive program of reforms. Nonetheless, it was the general view that, even in the present circumstances, and despite the existing constraints, the adjustment process should yield a significant response. It was, however, recognized that there were compelling reasons for the continuation of administrative controls in some strategic areas of the economy, and this would inevitably affect the pace of decentralization and decontrol.

Finally, speakers noted the important role of the donor community in the provision both financial support and of technical assistance. The adjustment process was likely to be long and difficult. The sustainability of the program would depend on the commitment and determination of the Government, and on an adequate flow of external resources and debt relief required to complement the efforts being made by the Mozambican Government. The important role of the Special Program of Assistance for Debt-Distressed Countries was cited in this regard. In addition, the importance of efficiently employing the available resources was noted, and the crucial role of the ongoing public expenditure review was underscored.

Mr. Abdallah made the following statement:

The structural adjustment arrangement with Mozambique has proven to be effective both as a catalyst for mobilizing external support for the country's adjustment effort and as a conduit for strengthening cooperation between the Fund and its authorities.

Much of this is attributable to the steadfast commitment of the authorities to the adjustment process and the pragmatic approach that the staff has taken in their dialogue with the authorities. The request for the second annual arrangement under the structural adjustment facility is evidence that the authorities are moving forward with their economic restructuring program, and that they fully appreciate the vital role that the Fund can continue to play in this endeavor.

The seriousness of Mozambique's economic problems called for concerted effort to transform the structure of the economy and to create an institutional setting conducive to the enhancement of economic efficiency and social welfare. The scope of the measures implemented in 1987 shows that the adjustment process has gotten off to a good start. Difficult decisions have had to be taken which affected the key areas of the economy. The exchange rate has been managed in a most flexible manner, the pricing system is being progressively liberalized, the budget has been placed under stricter control, steps have been taken to encourage private sector initiative, and efforts have been made to improve the planning process.

These measures have helped to generate a more favorable climate for economic activity. The recovery which began in 1986 was sustained in 1987, with real GDP increasing by nearly 4 percent, and there was also an increase in the supply of essential commodities. In addition, some progress was recorded toward containing growth of the money supply, government borrowing from the banking system to cover the budgetary deficit declined, and relations between Mozambique and its external creditors improved. Also, the differential between the official exchange rate and that of the parallel market was substantially reduced.

Notwithstanding these developments, unemployment remained a major problem, and inflation, reflecting in part the widespread liberalization of administered prices, eroded real wages. Meanwhile, the shortage of skilled manpower and disruptions to normal activity caused by military incursions continued to be serious constraints on Mozambique's ability to fully harness its potential to enhance economic growth and development in the longer term.

The authorities are aware that much remains to be done, and have kept in close contact with the Fund and the World Bank in the ongoing process of adapting their adjustment strategy to changing circumstances. They have agreed upon policies and objectives for 1988 as specified in EBS/88/40. These policies and objectives are consistent with the general thrust of the Government's medium-term economic rehabilitation program adopted last year. The focus of the program is to achieve a further relaxation of structural rigidities as the building block toward sustained economic growth and financial stability. Specifically, the authorities intend to progressively reduce administrative controls, permit greater reliance on price signals based on market forces, and direct resources into productive investment.

Exchange rate management continues to be a key element of the authorities' drive to economic efficiency. In this connection, the currency was again devalued in January 1988, the third such adjustment since the rehabilitation program was launched. Together, these adjustments amount to a 91.5 percent depreciation in foreign currency terms and reduce the gap between the parallel and official rates to 50 percent. With the commitment to a flexible exchange rate policy, it is envisaged that steps will be taken to further reduce the gap between the official and parallel market rates during the course of the year. Meanwhile, measures are being put in place to limit administrative controls in the trade and payments regime.

Additional price increases for consumer goods are to be announced soon, and on average will triple the prices of the main rationed commodities in the major cities. To enhance the effectiveness of this policy, the number of commodities subject to fixed pricing was reduced in January 1988, with further reductions expected by the end of the year. Prices that remain fixed will be adjusted for exchange rate changes. Producer prices have been increased between 50 percent and 75 percent for the 1987/88 season, bringing the cumulative increases to 350-600 percent since 1986. Further adjustments will be made as necessary toward the end of the year. Although agricultural output in the private sector responded significantly to price incentives, the authorities are aware that farmers need additional incentives in the form of extension services, an improved transportation system, and credit, among others. The Government intends to pay particular attention to these issues, in addition to taking steps to restructure state farms.

The authorities are committed to the goal of strengthening public sector finances and are engaged in the necessary administrative reforms to widen the tax base and to raise additional revenue. To this end, it is expected that measures to reform customs tariffs and improve tax collection as advised by the Fund will be implemented during 1988. Steps are also being taken to contain expenditure, including reducing budgetary subsidies and keeping wage increases below the anticipated increase in the price level. A comprehensive review of expenditures will be undertaken in 1988 to help set priorities for the coming year as well as to make the budget a more effective tool for medium-term planning. It is expected that government borrowing from the banking system will decline in 1988. The current deficit is also expected to decline relative to revenues and in real terms. In the event that revenues fall short of projections, timely corrective action will be taken, which might entail bringing forward revenue proposals that would have been implemented in 1989.

The target for domestic credit reflects the authorities' desire to reduce inflation and strengthen the balance of payments. A larger share of credit is being allocated to the private sector, with emphasis on productive investment. As regards the functioning of the banking system, the authorities are regularizing accounting procedures and working on removing other bottlenecks that have tended to impede efficiency.

Mozambique's balance of payments will remain under considerable pressure for the foreseeable future, and it is obvious that concessional debt relief is crucial if the authorities are to have room for maneuver. Against this background, it is unfortunate that the Paris Club has been slow in responding to the authorities' request for concessional interest rates. In addition to debt relief, Mozambique needs increased flows of concessional aid for general balance of payments support. Timely assistance from the international community will provide great encouragement to the authorities to continue along a course which is necessary for the country's stability and development.

Mr. Enoch made the following statement:

I welcome the successful completion of the first year of Mozambique's structural adjustment arrangement and commend the authorities for their continued rigorous implementation of the program. It is heartening to see substantial signs of recovery, particularly the reversal of the extended decline in economic activity experienced since the early 1980s. Clearly, both the implementation and outturn of Mozambique's adjustment program so far justify the exceptional support offered by the Fund and the rest of the international financial community in the form of this arrangement, of large-scale debt relief for an extended term and on the basis of the arrangement only, and also of substantial aid. This scale of response is only feasible within the framework of macroeconomic and structural adjustment provided by the policy framework paper and the structural adjustment facility, and in response to sustained and far-reaching reform. The depth of initial dislocations in the economy and the persistence of security problems unfortunately mean that the adjustment path ahead will remain arduous for some time. But there is little choice if Mozambique is to have any hope of eventual economic viability.

The necessary next steps are well articulated in the revised policy framework paper and second-year request under the facility.

Compared with the initial framework paper, this paper seems to have a much better grasp of Mozambique's problems and reflects not only the experience of the past year but also close Fund-Bank collaboration. The paper's approach is correctly sober in its expectations of what can be achieved. It rightly places heavy emphasis on reviving the agricultural supply side through the liberalization of marketing and producer prices. Of course, the statistical picture of Mozambique is still opaque; the need to revise the current account target upward by $55 million because of previously unrecorded service payments is particularly disturbing. This was an area of express concern at the time of our last discussion of Mozambique (EBM/87/158, 11/18/87), and I hope that the adjustment to the balance of payments is the result of deliberate progress and not an indication of statistical icebergs ahead.

The other serious concern about the latest framework paper is the absence of a prioritized public investment program. Such a program would seem important in view of past problems, the scale of capital expenditures, and the low implementation capacity of the country.

On the whole, the thrust of policies envisaged in the framework paper and in the second-year arrangement continue to be appropriate in seeking to free resources from the public sector through the reconstruction of public finances and to redistribute them within the framework of a liberalized price and distribution system toward the productive sectors that are capable of restoring growth and reinforcing the balance of payments. I welcome measures that have already been taken to free the agricultural sector and note that there has already been a significant positive supply response. It is critical that Mozambique continues to reduce the number of products subject to administered prices. It is, however, not clear how far the authorities ultimately envisage taking such liberalization. Perhaps future staff papers could offer some overall assessment of both achieved and intended liberalization measures. This chair commented at our last discussion on Mozambique that the ease of adjustment was likely to diminish as prices moved closer to underlying realities, and I note in that regard the comment in the staff paper that further structural reform is coming up against unhelpful attitudes and habits. Here, the ambitious pace and vision of reform are valuable instruments of adjustment in their own right in breaking through behavioral barriers.

Among the measures I would urge the authorities to pursue in this manner is the approximation of the official exchange rate with the parallel market rate, so as to remonetize barter sections of the economy, restore incentives, and improve the external accounts. Much has been done in this direction already, and I particularly welcome the authorities' commitment to "ratchet" reductions in the differential between the two rates. However, it is important to reduce the differential as much as possible before adopting a more gradual and formalized exchange rate mechanism.

I also urge the authorities to move toward a realistic tariff structure. There may be considerable scope for the elimination of quantitative restrictions, although I fully understand Mozambique's desire to move prudently in this area. I welcome the announced intention to replace some import restrictions by a reformed tariff structure. But perhaps more could be done, for example, in eliminating trading and transport monopolies.

On the fiscal side, only a small decline in the fiscal deficit is expected over the 1988-90 period, and the deficit is expected to stay at over 20 percent of GDP throughout that period. It is extremely important, therefore, that the World Bank's public expenditure review is quickly completed and acted on, and that the recommendations of last October's survey of parastatal enterprises is implemented. I welcome the action already being taken to control the current budget by curtailing subsidies and restoring the relationship between costs and prices. Continued efforts in this area are necessary if the authorities are to achieve their objective of eliminating the deficit on current expenditures by 1990. Advancement of the revenue package planned for 1989 would also seem prudent, and since it is reportedly feasible to advance the measures in response to unforeseen exigencies, this would seem practicable in any case.

I welcome the progressive monetary restraint introduced by the authorities and the expected fall in inflation, which will assist the liberalization of imports and the decontrol of prices. However, I would argue that interest rates must be set with reference, not to past inflation, but to inflationary expectations. And, although the strengthening of the banking system is welcome, efforts toward further reducing the extent of credit rationing are still required.

In conclusion, I note the wish of the authorities to negotiate concessional interest rates on their rescheduled official debt. My authorities recognize and accept fully the need for such concessionality. Indeed, the Chancellor of the Exchequer included such a proposal in the initiative on the debt of the poorest sub-Saharan African countries, which he launched a year ago and which he saw as an important complement to the Fund's enhanced structural adjustment facility and the World Bank's Special Action Program. Mozambique was one of the countries particularly in mind when drafting this proposal, which my authorities are continuing to pursue. However, until agreement can be achieved within the multilateral framework of the Paris

Club, it would be of limited practical use and unhelpfully divisive to unilaterally pre-empt a consensus decision. Finally, I endorse moving the second-year program period of the arrangement closer into line with the authorities' fiscal year. I can support the proposed decisions.

Mrs. Ploix remarked that she could fully support the proposed decisions. She was particularly pleased that virtually all of the first year's quantitative and structural benchmarks had been met. The authorities deserved to be commended for the strong commitment that they had demonstrated under the prevailing difficult circumstances.

Thanks to the timely implementation of the scheduled measures, a noticeable recovery of production had taken place in the agricultural sector, Mrs. Ploix continued. That recovery had led to a substantial increase in exports and a large improvement in the availability of consumer goods. In view of the encouraging response of producers and traders to the improvement of the incentive framework, growth prospects were most promising, even under the difficult present security situation. Those improved prospects had been integrated into the revised policy framework paper, which was still realistic.

In spite of the impressive set of reforms initiated in 1987, much remained to be done to achieve sustainable growth and a viable balance of payments situation, Mrs. Ploix observed. In that regard, it was encouraging to note the authorities' willingness to keep up the momentum of reform. She fully supported the priorities selected for reform in 1988 that appeared on the list of structural benchmarks for the second-year arrangement. In addition, credit reform--namely, the reform of the interest rate structure and of the criteria for extending credit--and the improvement of the management of public enterprises, including the privatization of some entities, would need to be actively pursued.

The authorities were well aware of the social costs involved in the adjustment process, Mrs. Ploix commented. Although generally the impact of adjustment on the population seemed to have been mitigated somewhat, thanks to the increased availability of goods, she was pleased that various measures were scheduled to buffer any negative impact on the poorest segments of society.

Mozambique had received substantial support from the donor community, Mrs. Ploix noted. Together with the stronger than anticipated response of the economy, the flow of external resources had allowed an upward revision of the framework paper's forecast in terms of imports and investments. As a result, the prospects for GDP and per capita consumption growth were also higher in the revised forecast. The role of the donor community would remain vital, but Mozambique must be aware that there was no consensus on concessional interest rates for rescheduled debt. The regularization of Mozambique's relations with its creditors was essential. It was therefore worrisome to note that delays had been registered in its discussions with

Paris Club creditors. Finally, Mozambique's eligibility for the resources to be provided by bilateral donors in association with the World Bank's program for low-income, debt-distressed countries would certainly contribute to easing the country's difficulties.

Mr. Goos made the following statement:

It is certainly difficult to assess Mozambique's adjustment effort by normal standards of Fund policy. There are only modest improvements in the overall fiscal deficit, widening gaps in the external current account, and, above all, little prospect for reaching a viable balance of payments position in the foreseeable future.

I am, of course, aware of the formidable constraints facing the authorities, notably the disruptive security situation and the resulting heavy burden for the budget. Against that background, the far-reaching policy commitments undertaken by the authorities under their policy framework paper and the commendable performance under the first structural adjustment arrangement, are impressive. It is most encouraging to note the substantial restructuring and constraint in the area of current fiscal expenditures, and I welcome in particular the substantial cuts that are being envisaged in consumer and enterprise subsidies.

Nonetheless, the precarious external situation reflected in the alarming level and direction of the debt service ratio clearly conveys an urgent need for the authorities to strengthen adjustment wherever possible. While I am in broad agreement with the thrust of the adjustment course envisaged under the second arrangement and also with the staff's recommendations, there are two policy areas in particular where more aggressive action might be called for, namely, the areas of interest rate and exchange rate policy.

I certainly appreciate the substantial steps already taken and the authorities' further intentions with regard to the adjustment of interest rates and the exchange rate. But an early unification of the parallel and official exchange markets supported by financial restraint and positive real interest rates would greatly facilitate the attainment of the authorities' principle program objectives. It would in particular help restore the "predominance" of official markets and improve the efficiency of resource allocation. The pace of exchange rate devaluation is persistently lagging behind the rate of domestic inflation, which indicates a continued loss of external competitiveness. Perhaps the staff could comment on this issue. In any event, I would hope to see substantial progress in this critical area as a result of the planned review of exchange rate policy, which should take place sooner rather than later.

In concluding, I encourage the authorities to finalize their bilateral agreements under the latest Paris Club rescheduling arrangement as soon as possible. There is no doubt that further debt relief will be crucial to support the authorities' ongoing adjustment effort, but, it is fair to say that the donor community has been exceptionally forthcoming with respect to Mozambique's financing needs--a fact that is also reflected in the substantial aid commitments for this year. For the time being it would appear advisable to conclude the bilateral agreements in the interest of timely closure of the remaining financing gap for 1987. Finally, I endorse the staff appraisal and support the proposed decisions.

Mrs. Walker made the following statement:

The Government of Mozambique has demonstrated a strong commitment to reform through rigorous implementation of its complex and difficult structural adjustment program in the face of external constraints. I commend the authorities for their efforts, which have entailed sacrifices for various sectors of the economy, and urge them to move forward with the second-year program under the structural adjustment facility with the same vigor and commitment as has been demonstrated thus far. It will not become easier to implement the needed reforms, particularly as they move beyond the "study" stage in some key structural areas, such as public enterprises, and begin the difficult implementation of reforms.

It was gratifying that the targets of the first-year program have largely been met. For the most part, events have continued in the direction that was reported at the time of the 1987 Article IV consultation with Mozambique, so I will not comment on the progress made last year. However, looking ahead to another difficult year of adjustment, there are several areas where particular attention should be focused, and some areas where the scope and pace of the reform program could be increased. In view of the seriousness of the economic situation and the apparent inability to achieve balance of payments viability in the medium term, every effort should be made to accelerate movement toward more explicit targets, particularly in the areas of prices and the exchange rate. In addition, the continued reduction of public sector control over the economy would be desirable.

The continued improvement of public finances remains a critical element to achieving the program's results. It will be essential that the budgetary requirements of the public sector do not crowd out the credit requirements of the productive sectors. A restrained wage policy, austerity in purchases of goods and services, and reductions in consumer subsidies and subsidies to public enterprises will be necessary to improve expenditure reduction. I note that the study of 40 public enterprises has been completed; what action is planned, based on the results of this study? Also, I would have preferred to see the inclusion of a benchmark on these reforms in the arrangement.

I note that the expenditure review has not yet been completed. Earlier progress on this review had been expected, since its implementation will be a critical element of the overall program of fiscal improvement. It is disappointing that this review could not provide recommendations for the 1988 budget.

Regarding the revenue measures contemplated for the 1988 budget, I urge the authorities to implement the new revenue package soon in order to increase the speed of fiscal adjustment.

I welcome the exchange rate adjustment that has occurred thus far and the associated pass-through to prices, including that which occurred recently. However, the difference between the official and parallel rates remains large, and more movement of the official rate is clearly called for. In addition, it will be important that the rate is managed flexibly and, in this regard, delaying the introduction of a more flexible exchange rate regime until 1989 may not be appropriate. Not only does this delay the introduction of an appropriate exchange rate mechanism, but it also delays further movement on associated exchange control and trade liberalization. The need to maintain some controls while the exchange markets are being liberalized is understandable, and in this context, the planned improvements in the efficiency of exchange allocation procedures is welcome. However, I believe that the pace of liberalization of the exchange rate could be increased as well as the associated liberalization of exchange controls.

The changes in prices that have been implemented are welcome, and I support the authorities' intention to consolidate the progress made on this front in 1988. It will be critical that the pricing policies reflect underlying market forces. In this regard, price developments in the wake of further devaluations will be followed with interest.

I am concerned that in spite of all of the authorities' efforts, Mozambique's balance of payments position will remain difficult in the medium term, with the current account and overall deficits increasing. With such prospects, it is clear that significant additional concessional aid and debt rescheduling will be needed. In order for such flows to materialize, the authorities will need to remain on a firm adjustment track, with little room for slippage, particularly in the area of structural reform.

Finally, the Bank-Fund collaboration that has been demonstrated in this case is welcome.

Mr. Ouanes made the following statement:

Mozambique's economic performance during the first year of its program under the structural adjustment facility has been impressive. Nevertheless, the challenges facing the authorities remain considerable, notwithstanding the results achieved in 1987, especially in view of the prevailing security situation, the magnitude of the imbalances, and the deep-seated nature of the existing economic distortions. The authorities' economic recovery program represents an important step in dealing with the country's economic problems. However, the external payments situation will remain difficult, and medium-term balance of payments viability is not to be expected. This outlook is clearly a cause for concern and underscores the need for firm adherence to the objectives of the arrangement.

As I agree with the staff's conclusions and with Mr. Abdallah's statement, I will confine my comments to two general remarks. First, the strong commitment to a comprehensive restructuring program and the vigorous, uninterrupted implementation of the program have proved to be a powerful and effective catalyst for foreign concessional flows and debt relief. Last year's experience illustrates the high level of responsiveness of the international financial community to strong, comprehensive adjustment. The initial response of the donor community to the adjustment process has not only been sufficient to cover the projected external financing gap for the remainder of the program, but is likely to permit a strengthening of Mozambique's external reserve position. Therefore, it is crucial for Mozambique to persevere with the needed adjustment and to avoid policy slippages, so as to maintain the confidence of the donor community.

Second, the economy's responsiveness to the structural adjustment measures and the strong policy initiatives in the pricing and exchange rate areas have been very encouraging. The package of policies introduced in 1987, while not sufficient to yield the required growth, nonetheless contributes to the promotion of an environment conducive to the efficient allocation of resources in general, and to a more effective utilization of both domestic and external resources in particular. Once the security situation improves, the country will be in a position to resume sustainable growth at a satisfactory level.

In conclusion, notwithstanding the difficult circumstances of the country, it is essential that the authorities continue to vigorously implement their economic recovery program. Policy slippages are particularly costly for Mozambique because of its heavy reliance on external concessional resources, which, as recent experience has shown, are becoming increasingly eclectic and tend to flow mostly to countries with a genuine desire for sustained reforms and a good track record for servicing their debt. I support the proposed decisions.

Mr. McCormack made the following statement:

After several years of severe economic imbalances, Mozambique has initiated a process of economic reform, which, if sustained over a long period, could eventually put the economy back on a viable growth path. Extensive policy reforms have been introduced, as evidenced by reforms in exchange rate management, trade and pricing policies, and a general orientation toward a more market-based strategy, and already there has been an improved economic performance during 1987. However, the scale of imbalances, both internal and external, and the constraints under which this program is being carried out--political instability, shortages of trained manpower, and bottlenecks in transportation--make projections more hazardous than usual.

The authorities must therefore continue to show their commitment to this policy framework, even though the adjustment costs may seem high and the correction of imbalances distant at this time. In recognizing these difficulties, the staff has adopted a pragmatic approach in policy design, leaving in place certain features that would ordinarily be questioned in Fund programs. It is equally clear that viability will not be achieved by the end of the program period and that exceptional financing will be needed in the years ahead.

Since I am in broad agreement with the policy prescriptions and the staff's assessment of the economic situation, I will be brief in our comments on policy. First, the authorities have made large discrete exchange rate changes to reduce the gap between official and parallel exchange rates. These adjustments, together with more realistic pricing policies, have increased the availability of essential goods, and industry seems to have benefited from them already. Inevitable lags in supply responses have meant that the full impact may not yet have been felt in the agricultural sector. In addition, the measures already taken need to be complemented by incentives in the form of extension services, improved transportation, and access to credit. However, the exchange rate must continue to be the primary policy instrument over the medium term, and I look forward to the elimination of the differential between the official and the parallel market rates as soon as possible as an important step in the move toward greater price stability and the restoration of confidence in the domestic currency.

In the area of fiscal policy, I support efforts to strengthen the revenue base and contain expenditures. The larger than expected reduction in consumer and enterprise subsidies is particularly welcome and shows that policy changes are beginning to take effect. I agree with the staff that it is now important to eliminate the deficit on the current account, thus minimizing any resort to domestic financing of the fiscal deficit. In this context, I am aware of the authorities' efforts to minimize the social costs of adjustment through wages and salaries adjusted for price increases. This practice should not become the norm in the current difficult environment. Capital expenditure is being financed by foreign inflows, but in view of the constraints mentioned earlier--especially with respect to labor--the authorities must be careful not to overextend the economy. In this context, the planned public expenditure review assumes particular importance.

Monetary policy presents somewhat different challenges to economic management since the financial sector is extremely underdeveloped. Priority may need to be given to training bank personnel so as to improve management and accounting in the banking system. In terms of policy, while it is necessary to avoid excess liquidity in the system, an expanded role for credit to the private sector will need adequate resources over the medium term. Although I appreciate the considerations set out on page 10 of the staff report concerning interest rate action in the present, rapidly changing circumstances, interest rates should, over time, be brought into better alignment with inflation. As a structural matter, the elimination of limits on lending rates would also be beneficial in terms of a better allocation of resources.

Finally, effective implementation of these comprehensive reforms clearly requires competent personnel. I would encourage the authorities to draw on the Fund's and the Bank's technical assistance programs to the fullest extent possible. I can support the proposed decisions.

Mr. Posthumus remarked that the Mozambican authorities should be commended for the vigorous implementation of the recovery program launched in 1987. The authorities, as well as the Fund and the international financial community at large, could look back on a satisfying first annual arrangement under the structural adjustment facility.

In view of the extremely difficult circumstances prevailing in Mozambique, assessment of the adjustment effort should give considerable weight to the quality and scale of the underlying policies, both macroeconomic and structural, and to their implementation rather than to their immediate results, Mr. Posthumus considered. Indeed, the overall domestic resource gap and external deficit had not yet declined and, barring alleviation of security problems, medium-term balance of payments viability was not to be expected. Still, the reform effort was clearly there and should continue vigorously in order to provide a sound basis from which Mozambique could emerge from its problems.

It was striking that the pace of adjustment for reducing consumer subsidies was even more rapid than originally envisaged, Mr. Posthumus commented. However, the compensating wage increase had been uniform for all employees. The staff was completely correct in its judgment that that procedure was not an appropriate long-term model in view of the extent of unemployment and lack of skilled manpower. In that connection, it should be borne in mind that long-term adjustment consisted of many short-term steps.

Defense requirements had clearly left their mark in the area of fiscal policy, Mr. Posthumus observed. Consequently, a substantial strengthening of the public finances as provided for in the program was indeed most necessary. It was gratifying that the authorities had already been able to reduce their borrowing from the domestic banking system significantly.

The steep reduction of the differential between the official and parallel exchange market price was welcome, Mr. Posthumus continued. He understood that a comprehensive review of exchange rate policies was planned with the staff in the course of the year with a view to shaping policies for the period after completion of the large stepwise reductions. The word "flexible" had been used frequently in the staff report. He would be interested to hear about the staff's intentions for the review. Would there be a time in the foreseeable future when Mozambique's exchange rate policy could return to something other than a continuing slide?

Finally, it was striking that the draft decision provided for approval of exchange restrictions, as evidenced by payments arrears, Mr. Posthumus remarked. Mozambique's progress in eliminating arrears underlay that proposal, and in that respect, he tended to think that approval might indeed be justified, even before having discussed the staff paper on the general issue of approval of arrears. However, it was puzzling that the decisions taken by the Board on the occasion of the approval of the arrangement in June 1987 and on the occasion of the conclusion of the Article IV consultation with Mozambique in November 1987 did not include the approval of those exchange restrictions. Although the situation then with respect to arrears had been radically different from what it was at present, he considered that the present proposed decision on the exchange system was appropriate.

Mr. Fogelholm remarked that the Mozambican authorities should be commended for their immense efforts during the past year in undertaking both policy adjustment and wide-ranging structural reforms. It was particularly pleasing to note that all quantitative financial benchmarks had been observed and that almost all structural and other measures set out under the 1987 program had been implemented fully and on schedule. In view of the economically disruptive security situation, the progress achieved so far was indeed encouraging.

Despite those good developments, much needed to be done in the coming years, Mr. Fogelholm considered. The continuing high resource drain for military and security purposes remained; in the past four years roughly one third of current expenditures had been for that purpose and almost the same relative amount was forecast for 1988. The repercussions on all areas of economic activity must, in such a situation, be substantial as well as constitute a continuous risk for further economic progress.

Nevertheless, the staff had reported some positive developments in the fiscal area, Mr. Fogelholm noted. Price corrections had been taking place, subsidies had been cut more rapidly than originally envisaged, and the authorities intended to prepare a new revenue package. He concurred with the staff that the envisaged reforms should, if possible, be implemented already during 1988.

Altogether, the planned actions for the fiscal domain in 1988, which included a further reduction in subsidies, the strengthening of public enterprises' financial management, and the further deregulation of the banking system, deserved the Fund's full support, Mr. Fogelholm continued. The authorities should also be supported in their intention to lessen the Government's domestic bank borrowing to less than one half of the 1987 level in real terms. Following those institutional changes, the next important challenge would be to align interest rates with the rate of inflation in order to gradually bring about positive real interest rates and thereby improve the efficiency of capital allocation.

The exchange rate policy during 1987 and early 1988 had been well founded, Mr. Fogelholm considered. The next steps should aim at fully eliminating the differential between the official and the parallel market rates, and after that, maintaining a policy of flexible exchange rate management.

It was obvious that medium-term balance of payments viability was not achievable and that the country would have to rely on foreign assistance for many years to come in order to be able to manage its external accounts, Mr. Fogelholm remarked. He was fairly optimistic that the necessary aid would be forthcoming if Mozambique persevered with its adjustment efforts and kept the present economic recovery program on track. In view of the complexities involved, the authorities would be well advised to seek technical assistance both from the Fund and the Bank. Finally, he supported the proposed decisions.

Mr. Hammoudi made the following statement:

The Mozambican authorities are to be commended for their continued efforts to restore the economy despite severe adverse exogenous factors, including natural calamities and imposed security problems. The outcome of these efforts include, in the main, an increase in real GDP, which is estimated at about 3-4 percent in 1987; the achievement of all financial targets for 1987 relating to the budget, domestic credit, and external borrowing; the implementation of the quarterly benchmarks on total domestic credit expansion and net bank credit to the Government; and changes in the exchange rate and official domestic prices, which are now more market determined. Furthermore, it is gratifying to note that private sector initiatives are being encouraged and that productive investment is being emphasized by the authorities. These efforts will clearly lead to strengthening the balance of payments and reducing inflation.

As I broadly agree with the policy measures indicated in the authorities' letter of intent, which are in concurrence with the thrust of the staff's conclusions, I will confine myself to only a few comments.

The authorities are determined to overcome financial and economic difficulties with the support of the Fund, as indicated by their request for a second annual arrangement under the structural adjustment facility. They intend to implement further structural reforms to boost incentives for production and improve marketing and resource allocation. The flexible, efficient manner with which the authorities' cautious management of macroeconomic policy is proceeding will facilitate the implementation of ongoing reforms.

The main components of this program are consolidating public finances so as to improve the revenue system, limiting current expenditures, and bringing about more discipline in financial management and the public enterprises. Wage policy will be restrictive, and subsidies will be reduced. Rehabilitation and maintenance will be the key objectives of the capital budget. The authorities aim at eliminating the deficit by 1990.

Market orientation will be the basis, in the medium term, for domestic credit, exchange rate management, trade, prices, and wages so as to eliminate restrictions as well as the parallel markets, whose gap with the official markets has narrowed sizably with respect to foreign currencies and consumer prices. The rural population will continue to benefit from the special attention being given by the authorities to monitoring, in particular, the cost of living so that it will not become unbearable.

Strengthening the balance of payments is one of the most difficult tasks facing the authorities in view of the uncertainties stemming mainly from the security situation and the shortage of skilled manpower. Accordingly, I fully share Mr. Abdallah's concern that "the shortage of skilled manpower and disruptions to normal activity caused by military incursions continue to be serious constraints on Mozambique's ability to fully harness its potential to enhance economic growth and development in the longer term." Under these circumstances, the role of external financing in terms of concessional flows and debt relief would be most crucial to alleviate the continuous shortage of foreign exchange which currently characterizes the balance of payments situation.

With regard to additional resources, while I welcome the support of the World Bank and the Fund through the Special Program of Assistance and the structural adjustment facility, respectively, I wonder if the transformation of the present arrangement into an enhanced arrangement is contemplated. Finally, I can go along with the proposed decisions.

Mr. de Groote remarked that he supported the proposed decisions.

The staff representative from the African Department, explaining the relationship between price adjustments, exchange rate developments, and interest rates, noted that since the inception of the program, the metical had depreciated by about 1,000 percent in local currency terms. The staff's initial concern had been that the pace of price adjustments would not keep up with the pace of exchange rate reform, and it was gratifying to see that the adjustments in administrative prices were indeed taking place. Nevertheless, as indicated in the letter of intent and the revised policy framework paper, the authorities desired to bring the official exchange rate into closer proximity with the parallel rate, and further major efforts in that regard would be undertaken by mid-1988. In that connection, he recalled that one speaker had suggested that the introduction of more flexible management should not await 1989, but should take place in 1988. It should be noted that although some details of exchange rate management had not yet been worked out, at a minimum, the official rate would be moved frequently--on a monthly basis--in the second half of 1988 to ensure that the differential between the two rates did not exceed its level at the end of June 1988.

In the staff's judgment, it was not necessarily sufficient to focus on the differential between the official exchange rate and the parallel market rate, the staff representative continued. Indeed, if the two rates had been consolidated at the inception of the program when the parallel market rate was about 1,600 meticais per U.S. dollar, the evolution of prices might not have been as favorable as it was at present. In assisting the authorities to introduce some flexibility in exchange rate management, the staff sought to avoid a situation where, although the gap between the official and parallel rates might be narrowing, the composite rate was not moving in the right direction. It would prefer to see flexibility with no increase in the gap until a more comprehensive formula could be worked out that would take additional factors into account.

The staff was well aware of the gap between domestic interest rates and the recorded rate of inflation, the staff representative from the African Department commented. If the program was implemented as foreseen, by the end of 1989 the measured rate of inflation, following midyear adjustments, could well be on the order of 20 percent, although this would still result in an annual average price increase of about 30 percent. That outcome would signify major progress in more closely aligning interest rates and the rate of inflation. At the same time, the authorities and the staff were continuing their dialogue on interest rates, which would be an important item on the agenda for discussion at the time of the next Article IV consultation with Mozambique.

The staff representative from the Exchange and Trade Relations Department recalled that Mr. Posthumus had noted the improvement in the draft decision in respect of exchange restrictions. Indeed, the approval of arrears was standard practice in such cases. As for a possible arrangement for Mozambique under the enhanced structural adjustment facility, discussions on that matter were at present extremely tentative.

The Executive Board then took the following decisions:

Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Mozambique has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Mozambique in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/88/68, 2/25/88).

3. The Fund approves the arrangement set forth in EBS/88/40, Supplement 1.

Decision No. 8826-(88/54), adopted
March 30, 1988

Exchange System

The Fund grants approval for the retention by Mozambique of the exchange restrictions evidenced by external payments arrears, and of the exchange restrictions remaining pending the execution of the rescheduling agreements with each individual creditor until December 31, 1988 or until the conclusion of the 1988 Article IV consultation with Mozambique, whichever is earlier.

Decision No. 8827-(88/54), adopted
March 30, 1988

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/88/53 (3/30/88) and EBM/88/54 (3/30/88).

3. HAITI - 1987 ARTICLE IV CONSULTATION - 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 period for completing the 1987 Article IV consultation with Haiti to not later than April 22, 1988. (EBD/88/10, Sup. 1, 3/28/88)

Decision No. 8828-(88/54), adopted
March 30, 1988

APPROVED: November 28, 1988

LEO VAN HOUTVEN
Secretary