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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/55

3:00 p.m., March 31, 1988

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

Executive Directors	Alternate Executive Directors
A. Abdallah	
F. Cassell	
	Jiang H.
C. H. Dallara	
J. de Groote	J. Prader
A. Donoso	E. V. Feldman
	A. M. Othman
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
	D. McCormack
Mawakani Samba	C. V. Santos
	I. A. Al-Assaf
	B. Fuleihan, Temporary
G. Ortiz	L. Filardo
J. Ovi	
	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. Toft, Debt Management and Financial Advisory Services. African Department: G. Kuhn. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; S. J. Anjaria, E. Brau, G. G. Johnson, H. B. Junz, S. Kanesa-Thasan, K. P. Regling, L. M. Valdivieso, D. M. Watson, N. E. Weerasinghe. External Relations Department: A. F. Mohammed, Director; P. C. Hole. Fiscal Affairs Department: T. M. Ter-Minassian, Deputy Director; A. Cheasty. IMF Institute: O. B. Makalou. Legal Department: T. M. C. Asser. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; W. M. Corden, M. P. Dooley, D. Folkerts-Landau, E. Hernández-Catá, M. Khan, P. Wickham. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; M. N. Bhuiyan, W. L. Coats, S. I. Fawzi. Western Hemisphere Department: S. T. Beza, Director; C. S. Lee. Bureau of Statistics: C. Briancon, R. T. Stillson. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. E. Archibong, K.-H. Kleine, P. Péterfalvy. Assistants to Executive Directors: F. E. R. Alfiler, H. S. Binay, F. El Fiky, S. K. Fayyad, V. J. Fernández, M. Hepp, L. Hubloue, S. Rebecchini, A. Rieffel, S. Rouai, Wang X.

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

The Executive Directors continued from the previous meeting (EBM/88/54, 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).

The staff representative from the Exchange and Trade Relations Department observed that a number of questions that had been raised by Directors had subsequently been answered by other speakers during the discussion. For example, Mr. Kafka and Mr. Feldman had addressed the question of the time frame of adjustment programs, and a question regarding front-loading had been answered by Mr. de Groote. As for comments that the staff paper's discussion on the positive elements of the debt strategy was too brief, or that not enough attention had been given to the growth-oriented adjustment process, the staff considered that those issues had already been extensively set forth in previous staff papers and Board discussions.

The issue of debtors' sharing the discount on claims in the secondary market and developments in that market would be addressed in a forthcoming staff paper, the staff representative remarked. In brief, the main points to be considered were that the secondary market was not a "normal" market, but was instead partly a cash market and largely a barter market; consequently, it was difficult to base any conclusions on the "market price." For most exchanges, the actual price would be less than 100, but where that price might lie within the range of quoted prices of 1 to 100 was not known. The drop in secondary market prices in 1987 reflected three major factors. First, there was more supply in the market owing to increased provisioning by banks and disinvestment by some smaller banks seeking to strengthen their portfolios or withdraw from an investment position they no longer wished to maintain. It was expected that in the future, portfolio shifts would occur mainly among those banks holding relatively large positions, and it was difficult to judge how secondary market prices might evolve in that situation. A second factor was the discontinuance of debt-equity programs in one or two debtor countries. The third factor was the move by a number of debtor countries to financing balance of payments gaps through the accumulation of arrears.

Whether it would be possible to drive a greater wedge between new and old claims on the basis of different interest rates in the market was related to another question regarding the need for interest margins to rise as re-entry vehicles became more relevant, the staff representative observed. Interest rate spreads on restructured debt, although they seemed high to debtor countries in relation to their capacity to pay, did not include the full perceived market risk, whereas a re-entry vehicle

would have to have a more market-related return. In view of the structural changes in the market, the normalization of debtor-creditor relations would imply a higher spread on new claims. Thus Mr. Cassell's proposal, if adopted by creditors and debtors, would be a positive evolution in the attempt to distinguish between old and new claims.

A question had been raised whether purchases of interest rate caps would be a substitute for an interest facility in the external contingency mechanism, the staff representative recalled. In fact, such purchases would operate more like an insurance scheme, whereby claims would not be paid if the person insured was not wearing a safety belt; the interest rate cap, or other hedging devices, would be the safety belt. Obviously, considering the volume of outstanding debt, it would be hard to negotiate caps for old claims, but there were indications that caps on new claims could be purchased and at rates that were not inordinately high, depending on the degree of security sought. More important, it might be possible to negotiate such caps within rescheduling agreements.

As for the staff's concept of equivalence, in the past, burden sharing among creditors and within groups of creditors had been measured by relative increases in exposure, the staff representative remarked. With the development of the menu approach and the blending of debt-increasing and debt-reducing options, changes in exposure were no longer a good measurement of burden sharing. That fact had led to the staff's view on the need for a different approach to measuring equivalence.

In choosing the base year for the terms of trade shown in Table 1 in the main staff paper, the staff recognized that 1980 was a bad year, but consistent data on the terms of trade since 1978 was available for only three of the fifteen countries under consideration, the staff representative noted. The staff would be giving priority to developing an improved data base.

The staff's reference to an unproductive degree of linkage between Fund programs and the banks' financing packages was not meant to imply that any linkage was unproductive, the staff representative from the Exchange and Trade Relations Department remarked. Linkage was a positive element, but it had certain unproductive aspects. For example, it tended to inhibit early repurchases from the Fund because under some financing agreements, such repurchase would trigger repayments to all banks; or, if there was any slippage or delay in Fund disbursements, the right to new money disbursements might lapse.

Mr. Ortiz recalled that a question had been raised regarding the usefulness of the distinction drawn by the staff between those debtor countries which were within a reasonable distance of returning to voluntary lending and those which were not. The point was that perhaps the staff's view was too optimistic, since some highly indebted countries which had performed reasonably well and had attempted to re-enter the market--for example, Venezuela and Colombia--had encountered difficulty.

Another staff representative from the Exchange and Trade Relations Department remarked that Mr. Ortiz's point was well taken. Indeed, even Venezuela and Colombia, among countries which had lost access temporarily in the past, had managed to re-enter the market only to a limited extent and following difficult discussions. The number of countries returning to the market was disturbingly small, and a question remained regarding the willingness of banks to respond within a productive period to countries which sought financing on the basis of their adjustment record. Nevertheless, it was important to examine that response because it represented one of the litmus tests for the success of the strategy. In that respect, the categories used by the staff were valid, especially as bank financing had, in fact, been mobilized for most of the heavily indebted middle-income countries.

The Chairman made the following summing up:

Executive Directors noted significant successes in the debt strategy, including, notably, progress in adjustment and subsequent resumption of growth--albeit at a less than desirable pace--in a number of debtor countries, strengthening of the financial system, and reaffirmation of the cooperative effort between creditors and debtors in the debt strategy. Against this stood first, relatively slow growth prospects for global trade; and second, growing reluctance of private sector creditors to increase their exposure through financing packages, coupled with some unease on the part of countries with already high debt service burdens to increase their debt levels.

All Directors stressed that any restoration of normal debtor-creditor relations was dependent upon effective implementation of comprehensive economic programs. Nevertheless, they expressed concern that, even where such efforts had been proceeding, the time frame needed to restore access to voluntary bank financing was protracted. Until such restoration, concerted support from creditors and official institutions is essential to underpin progress. Directors recognized that in order to counter "adjustment fatigue," authorities in the debtor countries must be able to demonstrate that there is "light at the end of the tunnel" in terms of continued international financial cooperation and appropriate access to foreign savings. However, this depended, in turn, upon restoration of confidence on the part of both foreign and domestic savers, including a return of flight capital.

Some Directors suggested that the putting into place of a centralized facility could play an important role in permitting indebted countries to take advantage of the discount on a sizable part of their debt and they thought that the Fund would be the appropriate institution to organize and manage such a facility. It is clear, however, from the observations made by other Directors, that there was not the widespread necessary support

for having governments or international financial institutions directly or indirectly involved in a centralized approach to debt reduction. They considered that the steady implementation of the present strategy was the indicated route for countries to grow out of debt, and they were concerned that expectations that would be raised by calls for centralized approaches would detract debtors and private creditors from facing realities and putting into place adjustment programs and appropriate financing based on a case-by-case, market-oriented approach.

One of the promising developments of recent months has been initiatives such as the Mexico and Bolivia transactions leading to some form of "sharing the discount." Some Directors questioned the meaning of the discount in the secondary market in this connection. Several Directors observed that for debtor countries, reductions in the stock of debt can be an important complement to the provision of new financing. Many Directors have observed that further pragmatic initiatives that blend additional financing with techniques that work to reduce debt, voluntarily agreed between debtors and creditors, would be appropriate. It would be important that major creditor countries create a hospitable environment in the legal and prudential fields that is consistent with the further evolution of market-based financing techniques. For low-income countries such as Bolivia, the Fund and creditor countries could be of assistance in facilitating the putting into place of debt buy-back schemes inspired by this successful precedent.

The implementation of effective economic programs should facilitate the Fund's catalytic role and the assembling of adequate financing on a timely basis. Many Directors stressed that the Fund's support of such programs should continue to be based on firm assurances regarding their financing. Directors noted the deleterious effects that delays in completing financing packages have on adjustment programs. The dynamics of the menu of bank financing options can help address the "free-rider" problem, for example, through enhanced exit instruments. The Board will return to these questions when it considers the legal effects of approval and nonapproval of exchange restrictions by the Fund.

Directors agreed that the Fund should assist members in designing and putting into place both economic and financing programs that would achieve adequate cash flow, consistent with their medium-term prospects for exports and growth. Some urged the elaboration of alternative medium-term scenarios in this connection as well as further research efforts on issues in program design.

Directors noted the important contribution made by official creditors to the resolution of debt-servicing difficulties.

However, many Directors believed that the rescheduling process could gain, if official creditors were prepared to provide medium-term support through a multiyear framework agreement that leaves the precise terms and coverage to be determined annually or periodically.

Directors expressed satisfaction that major steps had been taken in 1987 toward ameliorating the situation of low-income countries, including actions by both the Fund and the World Bank to secure more adequate flows of assistance to these countries. Official creditors, on a case-by-case basis, are providing exceptional grace periods and maturities, and in some cases are rescheduling on the basis of programs supported by the structural adjustment facility. A number of Directors, however, urged a review of the application of market-related interest rates on rescheduled commercial debts, and they were encouraged by the ongoing efforts by official creditors to find appropriate solutions. Through the enhancement of the structural adjustment facility, the Fund itself is well equipped to support programs of macroeconomic and structural reform in the low-income countries. Directors underscored that the priority now is for these countries to proceed, without delay, in designing and firmly implementing such measures.

In sum, Directors considered that the Fund should continue to play a central role in the implementation of the evolving debt strategy. The most important elements were the design and implementation of economic programs that achieved an appropriate rate of growth on a sustained basis and restored external viability in a medium-term framework. For strong efforts in this direction, Fund support could be strong as well; extended Fund arrangements could play a role in this context, it being understood that stand-by arrangements would remain the Fund's normal financing instrument. Moreover, both the extended Fund and stand-by instruments would be strengthened by provision of contingent Fund financing through external contingency mechanisms. The Fund would need to continue to play a catalytic role in assuring that strong adjustment efforts are adequately funded through appropriate contributions by participants to the strategy. Thus, as has been stressed by several Directors, the multilateral institutions cannot take on the financing role that should fall to the private sector. Directors underlined that the Fund should continue to support approaches voluntarily agreed between debtors and creditors that would help bring restoration of creditworthiness within a reasonable time frame. The medium-term horizon contemplated in Fund-supported programs could contribute to that end by helping to break out of the past cycles of stop-go policy implementation and recurrent debt renegotiations. Several Directors, however, asked themselves whether in some instances it might not be preferable for the Fund to wait until debtors and creditors had arrived at realistic

understandings. Most Directors, however, believed that an active Fund role would be appropriate to foster the putting into place of financing assurances in a timely fashion. In that context, several Directors noted with concern that in some cases arrears to private creditors were becoming an important de facto method of balance of payments financing and that such an approach was most detrimental to orderly adjustment and to the restoration of creditworthiness.

Finally, several Directors felt that SDR allocations in appropriate amounts could facilitate the success of the strategy and would fit particularly well in the present circumstances of reserve stringency in many debtor countries.

Mr. Cassell observed that the discussion on the debt situation had been curiously unquantified, in marked contrast to the approach taken by the World Bank. It would be highly desirable that the two institutions try to find a common approach to quantifying the debt problem. In that regard, he understood that the World Bank was basing its projections on a higher rate of growth throughout the period than was used in the Fund's world economic outlook exercise. Failure to agree on debt forecasts could lead to confused discussion on the subject, particularly outside the two institutions.

The Chairman remarked that Mr. Cassell had raised a crucial point. The World Bank had taken a medium-term perspective, had based its forecasts on different assumptions, and had arrived at different results. The Fund's focus was on actual near-term prospects and policies and associated cash flows, and it was important that the membership understood the different basic assumptions underlying the projections of the two institutions. The two Research Departments could perhaps work together to facilitate the membership's understanding of the two different sets of projections, but at present the Fund's efforts might have to be limited to that approach.

Mr. Sengupta commented that Mr. Cassell's request might be met within the context of the Fund's forecasting exercises by some reference to the possible financing gap of indebted countries, based perhaps on the assumptions of the baseline scenario and the country's current policies. A medium-term debt scenario would provide a useful focus for the Board's discussion of debt issues and as a part of the entire world economic outlook exercise.

The Chairman remarked that the staff was developing such a medium-term scenario for debtor countries, which it hoped to present to the Board at the time of the discussion of the world economic situation. Although a medium-term debt scenario would make a valuable contribution to the Board's discussion of the debt problem, it would be imprudent for the Fund to reach conclusions regarding actions to be taken to finance gaps based on such a scenario and a member's precise growth objectives.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/54 (3/30/88) and EBM/88/55 (3/31/88).

2. MOROCCO

Extension of Stand-By Arrangement

Paragraph 1 of the stand-by arrangement for Morocco (EBS/86/262, Sup. 3, 12/17/86) is amended by substituting "April 30, 1988" for "March 31, 1988." (EBS/88/71, 3/28/88)

Decision No. 8829-(88/55), adopted
March 31, 1988

Exchange System

The Fund extends the approval of Morocco's exchange restrictions evidenced by external payments arrears and the exchange restrictions remaining pending the execution of rescheduling agreements with each official creditor until April 30, 1988. (EBS/88/71, 3/28/88)

Decision No. 8830-(88/55), adopted
March 31, 1988

3. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 87/126 (8/31/87) are approved. (EBD/88/88, 3/24/88)

Adopted March 30, 1988

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/79 (3/29/88) is approved.

APPROVED: November 28, 1988

LEO VAN HOUTVEN
Secretary