

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/48

10:00 a.m., March 17, 1987

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

Executive Directors

A. Abdallah  
Dai Q.  
C. H. Dallara  
J. de Groote  
A. Donoso  
M. Finaish  
G. Grosche  
J. E. Ismael  
A. Kafka  
  
H. Lundstrom  
M. Massé  
  
Y. A. Nimatallah  
G. Ortiz  
H. Ploix  
G. A. Posthumus  
C. R. Rye  
G. Salehkhoul  
A. K. Sengupta  
K. Yamazaki

Alternate Executive Directors

M. K. Bush  
H. G. Schneider  
E. V. Feldman  
T. Alhaimus  
B. Goos  
J. Reddy  
  
M. Foot  
  
C. V. Santos  
I. Al-Assaf  
L. Filardo  
S. de Forges  
J. de Beaufort Wijnholds  
C.-Y. Lim  
O. Kabbaj  
  
M. Sugita  
N. Kyriazidis

L. Van Houtven, Secretary  
L. Collier, Assistant  
S. J. Fennell, Assistant

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Also Present

IBRD: B. G. Kavalsky, Operations Policy Staff. African Department: A. D. Ouattara, Director; M. E. Edo, S. N. Kimaro. Asian Department: P. R. Narvekar, Director; A. K. McGuirk, B. J. Smith. European Department: B. Rose, Deputy Director; H. B. Junz, K.-W. Riechel, M. Xafa. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; C. Atkinson, G. Belanger, J. M. F. Braz, K. B. Dillon, G. G. Johnson, P. M. Keller, M. R. Kelley, G. R. Kincaid, D. A. Lipton, K. P. Regling, C. M. Watson. External Relations Department: A. F. Mohammed, Director; H. O. Hartmann, J. M. Landell-Mills. Fiscal Affairs Department: V. Tanzi, Director; A. H. Mansur. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, Director; W. E. Holder, R. H. Munzberg, S. A. Silard. Middle Eastern Department: Z. Iqbal, S. von Post. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; F. C. Adams, J. M. Boughton, W. M. Corden, M. C. Deppler, M. P. Dooley, P. Gotur, S. J. A. Gorne, R. D. Hass, P. Isard, M. D. Knight, F. Larsen, P. R. Masson, E. Y. P. Tung, M. C. Williamson. Secretary's Department: A. Akanda. Treasurer's Department: D. Berthet, D. Gupta. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Ferrán, E. Hernandez-Cata. Bureau of Statistics: J. B. McLenaghan, Deputy Director; C. A. Patel, A. K. M. Siddique. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, G. D. Hodgson, J. Hospedales, Khong K. N., J.-C. Obame, A. Ouanes, G. Pineau, I. Puro, Song G., D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, H. Alaoui-Abdallaoui, F. E. R. Alfiler, J. R. N. Almeida, O. S.-M. Bethel, F. Di Mauro, W. N. Engert, V. J. Fernandez, M. Hepp, G. K. Hodges, Hon C.-W., L. Hubloue, S. King, K.-H. Kleine, M. A. Kyhlberg, M. Lundsager, V. K. Malhotra, R. Manfredi Selvaggi, C. Noreiga, L. M. Piantini, S. Rebecchini, G. Seyler, H. van der Burg, E. L. Walker, D. A. Woodward, Yang W., I. Zaidi.

1. WORLD ECONOMIC OUTLOOK - PROSPECTS AND ISSUES

The Executive Directors resumed from the previous meeting (EBM/87/47, 3/16/87) their consideration of a staff paper on prospects and issues relating to the world economic outlook (EBS/87/39, 2/24/87; Cor. 1, 3/10/87; and Cor. 2, 3/12/87), together with background material on recent developments and prospects (SM/87/54, 2/25/87), and a statistical appendix (SM/87/55, 2/25/87). They also had before them a staff study, prepared in response to requests by some Directors at earlier discussions of the world economic outlook, on potential output in the major industrial countries (SM/87/40, 2/12/87).

The Deputy Director of the Research Department said that some of the more factual questions would be taken up on a bilateral basis with Executive Directors following the meeting. Referring to some of the more significant questions that had been raised, he noted first that Mr. Grosche had asked to what extent the current outlook had changed as a result of recent developments from the one depicted in the staff's tables and interpretations. As mentioned at the beginning of the meeting on the previous day (EBM/87/46, 3/16/87) the staff was in the process of updating and revising its estimates for the Interim Committee. Basically, the main change of assumption that would be reflected in the new projections was the updating of the base period for exchange rates from November 1986 to late February 1987. The opportunity had also been taken to look again at individual country projections where later information suggested some revision of the staff's estimates. A complete set of new estimates was not yet available, but as an indication of how the new figures were likely to differ from the old ones, he noted that the estimates of growth in the industrial countries for 1987 and 1988 might show some reduction. The reduction was likely to be very modest for most countries, with the single exception of Germany where the staff expected the estimate of growth for 1987 to be revised down from 2 1/2 percent to about 2 percent. That figure was not inconsistent with the range of estimates that Mr. Grosche had quoted private forecasters as having made for Germany. The combined industrial country growth rate would probably, therefore, fall from the estimate in the staff paper of 2.5 percent to perhaps 2.3 percent or 2.4 percent. The staff did not expect to revise the 1988 figures significantly.

As far as current account balances were concerned, the Deputy Director continued, the change in exchange rate assumptions implied that, following the initial J-curve effect, there would be some further reduction of current account imbalances. In relation to GNP, the imbalances of the three largest countries would be reduced, perhaps by an additional one quarter of one percent in 1988. The U.S. current account deficit, which was put at 2.9 percent of GNP in the staff paper, would probably be about 2.6 percent in the revised estimates, with similar reductions in the current account balances of Germany and Japan.

The final change in the current outlook, affecting particularly developing countries, was that because of the further weakening in real commodity prices since the initial exercise was undertaken, the terms of trade for primary producing countries were somewhat weaker, the Deputy Director added.

Continuing, the Deputy Director of the Research Department recalled that Mr. Massé and a number of other Directors had asked the staff for its view on the effects of a faster reduction in the U.S. fiscal deficit. Basically, the staff's assessment was that reduction in expenditure by the public sector would tend to reduce activity in the short term, but as time continued, it would strengthen the prospects for activity in the medium term and longer term. It was the same response that had been depicted in an earlier staff paper on the domestic and international effects of the U.S. fiscal position (World Economic Outlook: Supplementary Note 7, SM/85/76, 3/11/85). The caveat that needed to be entered in the case of the United States was that, given the size of the U.S. deficit and the degree to which it contributed to uncertainties, there would clearly be positive effects if the markets perceived that a credible and strong effort was being made to reduce the deficit. In the current climate of uncertainty surrounding the deficit and the likelihood of its reduction, additional action at the present time would have stronger offsetting positive effects than might occur in circumstances where the deficit was not such a cause for concern.

On a related question raised by Mr. Rye, Mr. Sengupta, and other Directors concerning the staff's view as to whether the crowding in of private expenditure would take place automatically, the Deputy Director stated that the staff did not believe that crowding in was an automatic process. It took time for the reduction in government expenditure to work its way through credit markets, through the expenditure decisions of private agents, and into an offsetting expansion in private spending. But the length of the lags with which that offsetting effect took place naturally depended upon the surrounding circumstances. At the present time, the staff believed that firm action to reduce the U.S. fiscal deficit in a credible way would be associated with a more rapid crowding in than might occur in other circumstances.

In future world economic outlook exercises, the Deputy Director said, the staff would pay greater attention to debt service ratios for industrial countries, extending the data in Table 5 of EBS/87/39, and to economic trends in smaller industrial countries as well, as had been suggested by Mr. Posthumus and Mr. Lundstrom. Mr. Posthumus had also asked whether the assessment in the staff paper was in favor of fiscal easing--as in the statement that Germany and Japan could moderate the pace of fiscal adjustment--or of fiscal restraint--as in the statement that the staff continued to believe in the medium-term fiscal strategy of those countries. The distinction to be made was between the short term and the medium term. The medium-term strategy of most industrial countries of limiting the size of the fiscal deficit was one that had been endorsed in discussions in the Board and in staff papers for the

past several years. But that medium-term assessment had tended to be qualified by the judgment that the speed with which progress was made toward that medium-term objective could be modified in the light of economic conditions prevailing at a given time. Based on the current belief that there would be a substantial withdrawal of fiscal stimulus in the United States, the occasion might be presenting itself for other countries to modify the pace of fiscal consolidation accordingly.

A number of the interesting questions raised by Mr. Salehkhrou were of more rhetorical character, the Deputy Director remarked, and he would take them up with him bilaterally.

Continuing, the Deputy Director recalled that Mr. Sengupta had expressed skepticism about several aspects of the staff's medium-term scenarios. Noting that the current account imbalances in the three largest countries would remain sizable, particularly in Japan and the United States, at the end of the medium-term period in 1991, he had asked why, if fiscal correction in the United States was not accompanied by the large increase in investment discussed in the staff paper, it would not lead to a strengthening in the external position. In a national income accounting sense, of course, if one item in a three-item identity changed but the second did not, the third must be the one that changed. The reasons why the staff had not picked up such an effect in the scenario was because it was difficult, with an unchanged exchange rate, to detect the mechanism that would induce the resources released from the fiscal balance to be channeled into the balance of payments. Obviously, there would be some crowding in tendency, but it had seemed to the staff that it was unlikely to occur without a positive incentive to channel resources into the balance of payments.

As for Mr. Sengupta's comment, made also by other Directors, that the increase in investment shown in the scenario for the developing countries looked implausibly large, the Deputy Director recalled first that the medium-term scenarios for developing countries were built up by aggregating the individual projections of country desks. In many cases, it was a matter of aggregating the medium-term scenarios for individual countries that had already come before the Board in some form in staff reports for Article IV consultations and papers on the use of Fund resources. In the world economic outlook, the aggregate consequences were shown of what the staff hoped the outcome might be in individual countries. As was implied in the staff paper, the increase foreseen in investment could be considered optimistically large. Although the staff would certainly agree that its achievement would require strong policies and favorable circumstances, it was not necessarily impossible.

In response to Mr. Yamazaki's question about the trend in the Japanese balance of payments to which the staff had referred, the Deputy Director recalled that in assessing the medium-term prospects for the large industrial countries, the staff had implied that after an initial correction in response to the recent appreciation of the Japanese yen, the Japanese balance of payments position would subsequently remain

strong--one of the reasons being the underlying favorable trend in non-price competitiveness in Japan. That trend, like all trends in economic series, was a measure, in a way, of the analyst's ignorance of underlying causes. But it was a fact that over past years in periods during which Japanese price competitiveness had been unchanged relative to that of the rest of the world, the Japanese balance of payments had tended to strengthen, leading to the assumption by the staff of such a favorable trend. That trend had been included in the medium-term projections, as Mr. Yamazaki had observed, but without having been accentuated and without assuming its reversal. Of course, if Mr. Yamazaki was right in stating that structural changes in the economy meant that that trend would no longer exist, the Japanese surplus would obviously be somewhat less large than the staff had projected it to be. However, in the absence of further information, it was difficult to assume anything other than that the past trend would be continued.

The staff representative from the Research Department noted that Mr. Ortiz had been puzzled by the lack of decline in per capita consumption for countries with recent debt-servicing problems, as shown in Chart 11 of SM/87/54. Data on the subject were not always very solid, but the staff had checked the figures, which corresponded to its expectations. It should be noted, however, that the chart referred to total consumption, and not just to private consumption. In addition, the figures for Mexico embedded in that chart did indicate a substantial decline in per capita consumption.

In response to Mr. Sengupta's request for an elaboration on the pricing behavior of countries that competed with U.S. producers, the staff representative observed that, insofar as exports of manufactures to the United States were concerned, there was no real reason to suppose a difference in the pricing behavior of, say, Japanese, German, or Swedish exporters of comparable products. They all seemed to be significantly influenced by U.S. domestic prices. The result had been a large squeeze in profit margins from the first quarter of 1985 to the fourth quarter of 1986, when prices of non-oil imports in the United States rose by only 6 or 7 percent, a small increase in relation to the depreciation of the dollar. If U.S. import prices were rising much more rapidly in the recent period than they had earlier, it might be simply because exporters were having to pass more of depreciation of the U.S. dollar on to U.S. consumers.

The Director of the Research Department observed that there were basically two types of problems in the world economy--particularly in an interdependent world--one of which concerned overall economic performance, and the other the disparity of performance across countries. Some of the arguments in the discussion could be classified in terms of those that were concerned with aggregate growth performance and those that involved distributional issues. As far as the latter were concerned, the gauge was the existence of great imbalances in the external sector. Part of the difficulty was that in correcting one of the two problems, the other

might be aggravated. Thus, if a country carried out a policy of contractionary demand management in order to correct an external deficit, other countries would have to pick up the slack to maintain the aggregate level of economic activity in the world, or otherwise ensure that their policies were sufficiently supply-sided to increase the aggregate level of economic activity in one way or another. Probably, the proper way to achieve that outcome was to increase the pie as much as possible and to ensure, through policy coordination and cooperation, an appropriate measure of international sharing of the responsibility. In that connection, Mr. Sengupta had asked whether it was possible for one part of the world to change its spending patterns, for instance, creating current account changes that would transmit and redistribute resources, as it were, to the rest of the world without necessitating extraordinary and unrealistic changes in investment and savings throughout the world. The only logical difficulty that he saw with that idea was the need to find a mechanism to bring about such a transfer. The obvious general channels of transmission were through exchange rates and interest rates, which was why there was so much concern about developments in respect of those rates.

In that context, the Director of the Research Department continued, he had been struck by the unanimous support of the Louvre Accord and the desire for exchange rate stability, for different reasons, of course. Some Directors had emphasized the importance of systemic discipline. Others had emphasized that the decline in the U.S. dollar should go no further if inflation was not to re-emerge; if the tradable goods sector in other countries was not to be damaged more than it had been already; or if overshooting was not to occur. The thrust of the debate thus seemed to be that there should be no more exchange rate changes. At the same time, in summarizing the discussion, it was necessary to take into account Mr. Dallara's remark that exchange rates were a manifestation of the fundamentals. The depreciation of the U.S. dollar had been sharp and rapid; as Mr. Grosche had emphasized, even necessary exchange rate changes must take place at the right speed. According to the staff estimates, and in light of prevailing exchange rates and prevailing policies, the projected imbalances in the world economy were very large. The question was how to meet the desire for exchange rate stability without a recession. The answers to that question led to the related unanimous call on the part of Directors for coordination and cooperation, and basically for a recognition that it was not a time for business as usual. Maintaining stable exchange rates would take more than a stroke of a pen; it required a very serious attitude toward other policies--namely, demand management, supply side and other macroeconomic policies--and that relying solely on the exchange rate would place a very tight straitjacket on the commitments that could be made in respect of those other policies. As Mr. Salehkhov had emphasized, the danger was that a perception of a zero sum game did not invite cooperation, whereas international trade was more than that--it was a positive sum game.

Referring to the suggestions of Directors with respect to the staff's methodology, the Director of the Research Department said that he had taken note of the two major areas of concern. First, with respect

to the scenarios, there had been an almost unanimous request for the staff to consider additional medium-term scenarios. In moving in that direction, which was no doubt the right one, what would be entailed and what such scenarios meant must be kept in mind. At one extreme, as Mr. Foot had hinted, projections that were not country-desk based but based rather on a broad model might be nice to have, but there was currently no such model and constructing one was a very serious undertaking. However, with the resources at hand, some work could be done on the scenarios. Indeed, it would be desirable to examine alternative assumptions in order to check the sensitivity of some of the projections, and the staff would do so. Some Directors, like Mrs. Ploix, were more interested in knowing how alternative assumptions would shade the outcome than in a set of new scenarios. The recognition that certain assumptions built into the baseline scenarios might lead to nonsustainable policies had been highlighted in the "tensions and uncertainties" section, but in a nonquantitative manner. One way to meet the desire for greater quantification of those tensions might be for the staff to view the examination of alternative assumptions as an attempt to provide a broader range of possible outcomes. In the next staff papers on the world economic outlook, an effort would be made to give alternative exchange rate scenarios, make alternative assumptions about fiscal policies, and to consider any other areas that Directors might wish to cover. Alternative scenarios should also help to alleviate the concern on the part of some Directors that the staff was either too optimistic or too pessimistic.

In connection with the staff's future work on the question of indicators, the Director of the Research Department went on, Mr. Dallara had suggested extending indicators to deal with some performance norms, thereby making them more useful operationally. It would be recalled that some Directors, during the discussion on indicators, had been eager to see a development of indicators from statistics into a more operational, quantifiable set of indicators. It was a delicate area, and the staff would need some guidance on how to proceed, but the staff would suggest some performance norms that might be useful in future work on the world economic outlook. An additional aspect of indicators, to which Mr. Zecchini had alluded, and on which there might indeed be room for further thought in a supply-side world concerned indicators of structural rigidity.

On the debt section in the world economic outlook, which he viewed, as did many Directors, as a bridge to the discussion on the debt strategy on the following day, the Director of the Research Department remarked that clarification of one important point was in order. Mr. Dallara had indicated that the concept of the debt overhang was unfortunate. Certainly, if concepts created ambiguity, then they were indeed unfortunate. It would be recalled that the dollar overhang had been a useless concept. But if the concept of the debt overhang was not a good one, it was nevertheless important to try to indicate what the underlying issue was. Technically, the concept was meant to indicate that the staff saw in the debt situation a broad array of difficulties and issues--debt service requirements, flows of financing, or flow commitments, and existing stocks. The overhang concept might give the connotation of too much or



too little in the way of flows. One way to approach the matter might be to distinguish between groups of countries, as Mr. Grosche had suggested--namely, between countries that were illiquid but were fundamentally solvent, and those that had deeper difficulties. The concept of overhang was thus perhaps more relevant to some countries than to others. The staff did not intend to prejudge outcomes by its description of the problem. But one important point that the staff had made intentionally was how to look at and analyze data in the most detached way while being able to make some constructive suggestions. For economists, the market mechanism was the best guide to arrive at a measure of the existing stock of debt--was there an overhang, and if so, was it too large or too little? A sustainable situation was associated with the convergence of the two ratios, which could come about through changes in either the denominator or numerator, as a result of policies to promote growth in economic activity and investment. Whatever options were discussed during the discussion of the debt strategy--and a broad range of such options existed--the view of the economic realities had to be tempered by market information. The discipline of the market was the guide in the extent to which those alternative options would be considered.

Mr. Kafka remarked that it was not as much a question of optimism or pessimism as of the downgrading by the staff over the past few years of its projections for the world economic outlook. The projections had never been upgraded, as he recalled. And once again, the staff had informed the Board that its projections, which had been made very recently, would have to be downgraded within the month. Obviously, the staff used objective figures, which it obtained from the area departments and from its models. His question was whether such repeated downgrading did not suggest a need to change the method by which those figures were derived.

The Deputy Director of the Research Department responded that the question of whether a systematic bias existed in the procedures had been in the forefront of the staff's minds. He agreed with Mr. Kafka that the staff had recently tended to be optimistic on the central feature of growth in the industrial countries. Every effort would be made to determine whether there was such a systematic bias. Indeed, an examination of the pattern to which Mr. Kafka had referred had been undertaken, with the help of an outside consultant. Within the next few months, the staff should be able to provide Directors with a thorough examination of the way in which the forecasts were generated, how the reality compared with the forecasts, and whether the comparison offered any guidance for future work.

At the same time, the Deputy Director of the Research Department commented that the downward revision by the staff of its projections could not be characterized as indicating a systematic bias. True, for the past three years, the staff's estimate of industrial country growth had, in the end, turned out to be lower than the initial projections, in all cases by a relatively small amount that nevertheless represented an important reduction in the growth rate for industrial countries. However, in 1983, the staff had had to increase its projections for

industrial country growth quite substantially during the course of the year. As far as developing country growth rates were concerned, he was under the impression that on balance the revisions over the past few years had more often been in the upward than in the downward direction. Admittedly, the staff had started with rather gloomy projections, which it had tended to revise upward, as it had in other areas as well. For example, with respect to inflation as far as industrial countries were concerned, the staff had normally overestimated inflation and the outturn had been a lower rate of price increase than had been projected. As a general picture, it would not be fair to say that the staff projections were always optimistic for all variables.

Mr. Sengupta remarked that presumably the fact that the price of U.S. imports had not increased by more than about 6 percent, whereas the nominal exchange rate of the U.S. dollar had depreciated much more, had led the staff to conclude that not only Japanese but other exporters as well must have been able to absorb losses in their profits. That conclusion was a matter of concern to him because the concept of the J-curve model was based on the faster response of prices than of volume to exchange rate changes. The sluggish response of prices must reflect the operation of another market mechanism, calling for a change in the model. For instance, if excess profits had been built up over a period of high appreciation of the U.S. dollar, prices of U.S. imports would not be adjusted until the U.S. dollar had depreciated sufficiently to absorb those excess profits and a normal profit situation was restored in the exporting country. The simulations in Table 8 in SM/87/54 showed clearly that the original impact of exchange rate change had a specific effect on the current account results, if the depreciation was the result of a fiscal correction. Further elaboration of the different simulations in the main paper on prospects and issues would have been helpful.

As for the problem with respect to the short-term projections, Mr. Sengupta said that he agreed with Mr. Kafka that if the estimates of growth had to be systematically revised, the methodology should be re-examined. The question that he had raised concerned the medium-term scenarios, specifically, the absence of a substantial change in the U.S. current account deficit after 1988--or even before 1988--even though several other variables had changed substantially. If those scenarios were drawn up not as projections, but as the possible course of the world economy in the medium term, alternative scenarios became very important, particularly because of the sensitivity of projections to changes in the assumptions. He found it hard to believe that the rate of private sector savings in the United States was declining, given the substantial change in the exchange rate, and the substantial increase in the rate of private investment. The fiscal deficit correction should compensate for the changes in the current account deficit, as a matter of arithmetical calculation, yet the U.S. current account deficit would remain on average at 2.9 percent of GDP from 1989-91.

Moreover, Mr. Sengupta remarked, the way in which the current account balances of the seven major industrial countries were matching up indicated almost no transfer of resources to the rest of the world. If that outcome was the result of using a particular model, it would be a matter of concern, but since it resulted from the staff's judgment of the way in which the international economy was probably moving, alternative scenarios should be developed that would provide for a flow of resources to the rest of the world. The question then became one of the specific policies that would have to be adopted to permit the realization of such a scenario. The Director of the Research Department had referred to creating mechanisms for the transfer of those resources. While the nature of the financial intermediation system might have to be reconsidered, to permit the deficit of the developing countries to be financed, an alternative pattern of balances would also be a matter that permitted making other assumptions about the domestic policies of the industrial countries. At some point in time, a more complete model of international economic cooperation would be desirable.

Mr. Yamazaki said that while he had no objection to the use of alternative scenarios for the purposes of theoretical analysis, their official use by the Fund would raise difficult, sensitive issues. For instance, assumptions about the fiscal and monetary policy of individual countries, especially if the results leaked out, could cause confusion and have an adverse effect on exchange markets. Private institutions were free to make whatever assumptions, and draw any kind of conclusions, they wished. But an organization like the Fund had to be extremely careful in undertaking such analyses because of the exaggerated significance attached to both the assumptions and conclusions, even if the latter took the form of mathematical calculations or were based on the hypothesis that certain conditions would remain unchanged.

Mr. Ortiz commented that it was apparently assumed in the medium-term scenario for developing countries that there would be no self-financing and that the current reverse transfer of resources of, say, 3-5 percent of GDP a year would continue in the medium term. Yet to be able to project a growth rate of 4 3/4 percent in the years after 1987, the staff was assuming an increase in the investment coefficient of approximately 4 percentage points of GDP, which would just about offset the reverse resource transfer. When medium-term scenarios had to be continuously revised, the realism of such basic assumptions was highly questionable, particularly given the depressed levels of consumption. The staff had provided a chart showing that total per capita consumption in developing countries had been maintained; no doubt government consumption included interest payments, which had increased greatly.

Mr. Salehkhon remarked that the Deputy Director's characterization of some of the issues he had raised as rhetorical questions--a view with which he begged to differ--supported the case for his proposal that Directors' statements should be published along with the staff report so that the public could make its own judgments.

The Deputy Director explained that in constructing the medium-term scenarios, the staff used the national income identity--but without being enslaved by it. The government fiscal balance, together with net savings and investment of the private sector, must be equal by definition to the current account. The way in which the staff made use of the identity might illustrate the behavioral relations that lay behind it. The government fiscal balance was in a sense given by the policy intentions of the authorities, modified in some cases by staff assumptions about the likely constraints the authorities would face in putting their intentions into effect. The current account was in large measure determined by two major price and income factors--the differential rate of demand growth in the domestic market and abroad, and the relative competitive position of a country vis-à-vis other countries. The staff projections had always assumed unchanged exchange rates, in accordance with the guidance of the Board, not because that would necessarily be the case but as a way of illuminating the tensions that might arise from the existing exchange rates. As far as the assumption with respect to demand growth was concerned, the policy instruments available to government to correct overheating or sluggishness in activity were such that traditionally it was assumed that the growth rate in the medium term would be similar to the rate of growth of productive potential. Relative domestic demand growth was thus given by the assumption that beyond short-term growth in output and demand, the growth rate would revert close to trend.

The current account position was thus determined by the two assumptions of an unchanged exchange rate and of growth relative to trend, the Deputy Director added. The remaining weight therefore had to be placed on the third of the three elements of the identity, namely, on the domestic savings and investment balance. That was why the staff characterized the outlook as a scenario and not as a forecast, and why it had attempted to illuminate tensions rather than trying to specify how certain tensions could actually be resolved by policy changes.

To take the case of the United States, to which Mr. Sengupta had referred, given the current exchange rate and a medium-term path of domestic demand in the United States and other countries that was based on the assumption of the attainment of a rate of growth of productive potential, the deficit in the U.S. balance of payments had been estimated in the range of 2 1/2 percent of GNP. The staff had not arrived at the conclusion that the current account deficit was the residual of a calculation; if anything, the fiscal deficit and domestic savings and investment were the residual. At the same time, the staff did not intend that its calculation should be accepted as the most likely outcome; the intention of the section on tensions was in fact to illustrate ways in which the outcome would be different because two elements that had been fixed were market determined and might change. Interest rates would tend to fall, if there was a weakness in activity, helping to crowd in spending from the public sector. Similarly, if balance of payments deficits were larger than private holders were willing to finance, the exchange rate would change.

Mr. Sengupta remarked that clearly the staff did have sufficient freedom to select the variables with which it worked with the objective of attaining a certain outcome in other respects. He understood that when the exchange rate was fixed, there was a particular kind of result. His point had been that if a change in the result was desired, some policy changes would be required, including but not necessarily only with respect to the exchange rate, because the savings and investment balance might be affected. If the configuration of imbalances emerging from the medium-term scenario was not acceptable, the possibility of building up alternative scenarios should be recognized and policy recommendations made for bringing them about.

The Deputy Director of the Research Department said that he agreed with Mr. Sengupta; in a way, the staff had hoped that its paper would constitute a qualitative scenario of how the assumptions and changes in policies would contribute to a more sustainable outcome. He took it from the discussion that it would be helpful if the staff provided actual quantified estimates of the extent to which the policy changes and changing conditions would operate to affect the outcome. As long as it was understood that the staff's choice of coefficients might be questioned by Directors, the staff could no doubt present such effects in quantitative terms.

The small net financial flow to developing countries seemed to the staff to be a realistic reflection of the financing possibilities of those countries, the Deputy Director stated. It would be unrealistic to assume, certainly in a basic scenario, that the problem of the U.S. deficit could be dealt with in some way by allowing the developing countries to run much larger deficits that would then provide the outlet for net exports of the industrial countries. Of course, in an ideal world, it would be desirable for there to be much larger financial flows to the developing countries, as had been recognized by the staff in the papers under discussion as well as on many previous occasions. At the same time, it had to be borne in mind that there was a group of countries that could obtain additional finance but that were simply unwilling to borrow more and wished to run large payments surpluses in order to repay debt or to accumulate reserves, as well as a group of countries that might wish to borrow more but found themselves unable to do so, given the present attitude of creditors. Increased flows to developing countries would of course also help to resolve the problem of reducing the imbalances among the industrial countries, but he repeated that there did not seem to be a realistic possibility for the time being.

The staff representative from the Research Department, referring to Mr. Ortiz's question about whether the maintenance of consumption in developing countries reflected interest payments, noted that Chart 11 was based on consumption in real terms. When interest payments were deflated, their impact was relatively diffused. The straight relatively sustained path of consumption in countries with recent debt-servicing problems, he

reiterated, obscured very dissimilar movements, for instance, for Mexico and Brazil. The data showed a large decline in consumption in Mexico, but not for Brazil or a number of other countries.

Mr. Ortiz remarked that he was not fully convinced by the staff explanation. Even if nominal interest rates had fallen, total interest payments as a proportion of GDP had not declined substantially. The impact of interest payments on measured consumption would thus not be insignificant in real terms. The aspect of the problem that he had had in mind in referring to consumption levels was the difficulty of making such an assumption as the one made by the staff for investment. Was it realistic to assume that investment would increase by 4 percentage points of GDP in order to compensate for the reverse resource transfer?

The Director of the Research Department commented that it appeared from the discussion that some dimensions of the staff input into the analyses were considered to be subject to a certain bias, but not all of them. It should be possible to know whether the forecasts could be improved when the consultant who was examining the matter submitted a report in the near future.

A different, more methodological question was whether it made sense, even if there was not a systematic bias with respect to growth to operate on a working hypothesis that investment rates would have to increase by a certain amount to achieve the desired increase in growth, the Economic Counsellor added. He believed that there was another mechanism. The preference of the Board, in suggesting that additional scenarios be presented, was to examine alternative mechanisms. In the paper before the Board, the staff had highlighted the tensions and the uncertainties in a separate, nonquantitative section.

The Deputy Director of the Research Department said that he agreed with Mr. Ortiz that the projected increase in the investment ratio by 4 percentage points of GNP over a period of four years was unusually large and must inevitably be surrounded by uncertainties. However, it should be noted that the projections represented an aggregation of a number of individual country assessments. For most of the individual countries that the Board had discussed on previous occasions, and given the recommended policies that the authorities of those countries intended to follow, the expected results should be achievable; but to expect that they could be achieved in aggregate for all of them would be a hopeful estimate. The scenarios should be viewed less as a prediction of what was expected than as a guide to what might occur in certain circumstances that were not beyond the realm of possibility, in the opinion of the staff.

As to the question raised by Mr. Ortiz about the feasibility of investment of the magnitude projected at currently low levels of consumption, the Deputy Director of the Research Department considered that the transfer on average of about 1 percent of GNP into the investment sector year by year should be achievable without squeezing real per capita

consumption. Although the terms of trade would not improve greatly from their present level, the staff's hypothesis was that they would not be deteriorating further.

Mr. Dallara considered that it would be worthwhile in the future for the staff and the Executive Board to give further thought to what was meant by the appropriateness of continued efforts for medium-term fiscal consolidation in Germany and Japan, and how that appropriateness would be evaluated. He was inclined to think that the issue was more fundamental than suggested in the opening remarks by the Deputy Director of the Research Department to the effect that it was the pace rather than the appropriateness of the pace of adjustment of fiscal consolidation that was important in present circumstances. The staff's own analysis indicated that a viable outcome in the medium-term balance of payments might require savings and investment changes in countries that were not clearly compatible with continued reduction in fiscal deficits over the medium term, even if those changes could be delayed for, say, 12 months. Possibly it was a matter of defining the medium term, and any differences of definition in that respect could perhaps be reconciled by taking a longer time horizon for medium-term fiscal consolidation. Nevertheless, the fact was that Germany's fiscal deficit was near or below 1 percent of GDP, and its tax reform plans were not revenue neutral. Thus, the objective of fiscal consolidation itself, rather than its pace, required some reconsideration of the direction of the movement in overall fiscal positions in the coming year or two. The fiscal situation in Japan was complex, with the central government position being rather different from the general government position. It was not entirely clear from the staff report for the 1987 Article IV consultation with Japan, or from the staff papers on the world economic outlook, whether the staff implicitly shared the emphasis of the Japanese Government on the central government position. Nor was it entirely clear to him, given the current medium-term outlook, that continued reductions in the Japanese fiscal deficit, even at a slower pace, were appropriate.

The questions that had been raised were not easy to answer, Mr. Dallara remarked, and he recognized that there was certainly a danger in any move away from a long held medium-term objective in order to deal with short-term considerations. But the issue continued to weigh on the minds of his authorities, not just from a policy point of view but from an analytical point of view as well.

Like Mr. Sengupta, he believed that the world economic outlook exercise could be considerably more useful if the Fund was willing and able to develop medium-term scenarios that had policy implications, Mr. Dallara added. Policymakers did not simply want to know that the medium-term balance of payments was unsustainable, but to have an understanding of how to reach a more sustainable position. Mr. Yamazaki's points with respect to the sensitivity of such matters and the need to avoid leaks were well taken. To meet such concerns, it might be necessary for the Fund to modify its publication policies somewhat. If the Fund were an academic institution, it would find it easier to talk more freely

and publicly, but the surveillance exercise was not an analytical one and it should be focused not only on enhancing the understanding of world economic developments and the way in which the world economy functioned, but in providing advice to policymakers.

Mr. Grosche commented that the concept of fiscal consolidation needed to be considered in greater depth, particularly since it could acquire a different meaning over time, as in Germany. The objective of his authorities at present was to continue in the medium term to cut expenditures in relation to GNP and to redistribute the gains through tax reductions. Less emphasis was being placed on cutting the deficit, which as an objective had become less important over time. Tax reform in that context could not be neutral; the question was to decide how much of the gain should be distributed and whether at some point the deficit could be allowed to rise again.

He supported Mr. Yamazaki's call for caution with respect to medium-term scenarios, Mr. Grosche said, especially on exchange rates. It would be necessary to resist the temptation to assume changes in exchange rates when at a particular point in time it might be desirable for exchange rates to remain relatively stable. Publication of the World Economic Outlook, if it contained any such assumptions, might encourage the belief that exchange rate policies were being reconsidered by the countries concerned. If a clear view of realistic policy options was conveyed in the sensitivity analysis, the reader could draw his own conclusion as to whether or not exchange rate action was required.

Mr. Yamazaki reiterated the points that he had made already with respect to Japan's fiscal stance. First, the Japanese Government had made strenuous efforts to streamline demand by emphasizing certain components of expenditure. Second, there seemed to have been some misunderstanding of the fiscal position generally. It was the accounts of the Central Government that indicated the underlying budgetary trend, and not the fiscal deficit of the General Government. The current surplus of the social security funds was expected to deteriorate rapidly in coming years, and could not be taken into account on the revenue side of the government budget. In the current year, central government debt would reach ¥ 155 trillion (US\$1 trillion), or 43.5 percent of GNP, with debt servicing accounting for more than 20 percent of total government expenditures. The debt would continue to increase yearly by ¥ 10 trillion. In face of that restricted budgetary situation, no change was possible at the present stage in Japan's policy of medium-term fiscal constraint.

He had been pleased to note Mr. Grosche's endorsement of his view on the sensitivity of the assumptions and figures in the medium-term scenarios of the world economic outlook, Mr. Yamazaki said. Although the Board's discussions on surveillance were and must remain strictly confidential, there was always the chance of misinterpretation by the market, particularly if more detailed scenarios were published.



Mr. Foot said that as he had made clear in his statement at EBM/87/46, he supported the use of alternative scenarios. What he had difficulty with, like Mr. Grosche and Mr. Yamazaki, was the concept of normative scenarios. The use of too many alternative scenarios often led to perverse but very understandable reactions on the part of the people preparing them, who tended to minimize the importance of the alternatives and emphasize the appropriateness of the preferred underlying scenarios. As the Economic Counsellor had mentioned, the world economic outlook exercise was already a labor-intensive process, and he hesitated to ask the staff to make it even more exhaustive. At the same time, a certain investment of resources seemed necessary in order to reduce the labor input in years ahead, although that was a matter for discussion in the context of the administrative budget and of the direction that the Fund should take as an institution in future years. In sum, although a model-based approach could be more illuminating, the fact that it might be expensive in terms of time would need to be taken into account in considering whether that would be the best way to proceed.

Mr. Sengupta considered that Mr. Salehkhoul's suggestion to publish the interventions of all Directors in some form or other should be discussed by the Board. There was a point in making available, at least to those who were guided by the results, the outcome of the Fund's exercise in surveillance, which was not an academic exercise.

The Deputy Director of the Research Department, in response to a question by the Chairman, explained that so far the Fund had published the staff papers, modified to take into account comments made during the course of the discussion. In addition, the staff had adapted the text to take account of any specific difficulties experienced by Executive Directors relating to the way in which a country's performance or policies were characterized. With respect to the medium-term projections, which had been introduced for the first time for the industrial countries in 1986, only aggregate figures and not individual country figures had been published. There was an obvious advantage to following the precedent that had been established, with the approval of the Executive Board. Other suggestions that had been made for broadening the coverage of the published document were of interest but would take longer to implement. It should be noted that undue delay in the publication of the basic statistics and analysis reduced the topicality of the world economic outlook.

Mr. Grosche, in response to a remark by Mr. Salehkhoul, said that he had no objection at all to medium-term scenarios for industrial countries. On the contrary, those scenarios should be developed along the lines discussed. He had wished only to emphasize the need for caution in making assumptions about exchange rate changes, because of the need to avoid creating the impression that the Fund had a certain idea of where an exchange rate should be at a particular point in time.

The Chairman remarked that he had been especially impressed by the calls for prudence and for respecting the confidentiality of the exercise. The Fund was accustomed to being prudent and to helping governments in policymaking; at the same time, it owed timely information to the public. However, with respect to Mr. Salehkhrou's point relating to the inclusion in the published World Economic Outlook of Directors' interventions, if Executive Directors saw some value in more extensive reporting to member governments of the Board's discussion on certain issues, they might wish to consider the matter among themselves before deciding whether it should be brought to the Board. He recalled that as a former Governor of the Fund, he had always received full reports from the Executive Director for France on the positions of all Executive Directors.

The Chairman made the following summing up:

Executive Directors' comments have covered a wide range of topics. I will organize my remarks around the four main policy issues raised in the staff paper.

First, however, it may be useful to record the views that were expressed concerning the staff's projections of prospective developments in the world economy. Directors generally agreed that output growth in industrial countries was likely to continue at a moderate pace in 1987 and 1988. A few Directors believed that the staff was conservative in its projections and that there was a reasonable likelihood of some acceleration of growth in the period ahead. A more widespread view, however, was that the staff had tended to err on the optimistic side. It was pointed out that recent indicators revealed weakness of demand and output in most of the major countries, and a number of speakers considered that this disappointing performance could persist for some time.

There was little dissent from the staff's projection that output growth in the developing countries would tend to slow down in 1987. Indeed, several Directors felt that the outcome could be even weaker than that projected by the staff. It was also pointed out that for many developing countries, even the relatively strong growth of output in 1986 produced no welfare gain, as the increased production had to be channeled into the balance of payments to finance substantial terms of trade losses. Several Directors observed that these losses for the fuel exporting and other developing countries had amounted to close to \$100 billion in 1986.

Looking ahead to the medium term, considerable skepticism was expressed about the attainability of the growth rate for developing countries that was foreseen in the staff's scenario. Many Directors felt that with modest growth in world trade, limited flows of external credit, and low commodity prices, an improvement in the growth performance of developing countries would require a very marked strengthening of domestic economic policies and performance. In particular, a number of speakers argued that the

increases in domestic savings and investment ratios embodied in the staff's projections were unrealistically optimistic. Other Directors, while conceding that the staff's projections were based on favorable assumptions, nevertheless considered that the scenario helped illustrate what might be achieved on the basis of firm policies.

On balance of payments trends, most speakers agreed with the staff that the current account deficit of the United States and the surpluses of Japan and Germany were likely to remain large in 1987 and 1988, as well as in the medium term. One or two Directors, however, pointed out that adjustments in the volume of trade flows were already considerable and could well become significantly greater in the medium term. As far as the payments position of developing countries was concerned, it was generally accepted that this would continue to be determined by financing considerations and would remain broadly in the range projected by the staff.

Coming now to the policy issues that arose from these projections, I will deal first with the observations that were made on the sustainability of payments positions and exchange rates. Most Directors agreed that the payments positions projected by the staff for the three largest countries raised questions of medium-term sustainability. It was noted that such a payments pattern would lead to a substantial buildup of net debtor and creditor positions that would have potentially troubling consequences for exchange market pressures.

Different views were expressed concerning how these prospective tensions could best be dealt with. It was generally agreed that policy initiatives to correct the U.S. fiscal imbalance and strengthen growth prospects in other industrial countries would make a major contribution to stabilizing the situation. In this connection, most Directors viewed the recent Louvre agreement as a major step toward a more viable payments pattern and more stable exchange rate relationships in the medium term. They underlined the importance of countries carrying through the policy commitments made at the Paris meeting. While noting that further rate movements might at some time be necessary, they felt that stability in rates was important at the present time. This would give markets the opportunity to absorb the large changes that had occurred.

Several speakers, however, noted that there was little sign so far of any narrowing in payments imbalances, and little evidence in the staff's projections that a significant narrowing would take place in the medium term. Under these circumstances, these Directors questioned whether the Louvre agreement would be sufficient to prevent the reemergence of exchange market pressures. Some

fears were expressed that the use of intervention to resist such pressures could be associated with a rise in U.S. dollar interest rates and a weakening of economic activity in the United States.

Second, on the policies required to sustain expansion in the industrial countries, there was no dissent from the proposition that the present level of the U.S. fiscal deficit remains a major source of concern and that reducing it should continue to be a central focus of policy efforts. Many speakers praised the commitment of the U.S. authorities to make substantial progress in lowering the fiscal deficit and encouraged them to reach the necessary compromises with Congress to enable this objective to be met. However, doubts were expressed about whether the "crowding-in" of private spending would be sufficient to avoid some slowdown in activity. It was recognized that the direct effects of deficit reduction on demand would be negative; however, most Directors argued that there would be offsetting positive effects from lower interest rates, improved confidence, and, in the United States, a strengthening in net exports.

For countries outside the United States, there was similarly no disagreement that robust growth of domestic demand is desirable. This is needed for a number of related reasons: to facilitate the correction of external imbalances; to compensate for the moderation of domestic demand in the United States; to help lower the high unemployment rates in many of those countries; to reduce protectionist pressures; and to help make the debt situation more manageable. There is, however, less agreement concerning the methods by which the desired pace of demand growth can be fostered. Most Directors felt that the scope for a more expansionary monetary policy was limited. While flexible monetary policy had helped support demand in the recent past, the room for further easing was circumscribed by the need to avoid a re-emergence of inflationary pressures. Several speakers stressed the importance of the pass-through to final consumers of the significant benefits of terms of trade gains arising from recent declines in prices of oil and other commodities. Moreover, most Directors considered that the current fiscal stance in Germany and Japan was too restrictive to be fully consistent with the desired pace of demand growth. They therefore welcomed the indications that fiscal policy in these countries would be eased. Indeed, many speakers urged the authorities to continue to be flexible and to keep further modifications in fiscal policy under active review.

The Directors from Germany and Japan, and some others, argued that manipulating demand was not a satisfactory means of fostering durable growth. Such a policy would run all the well-known risks of fine-tuning; it ignored the structural constraints that economies faced in accelerating growth; and it created the danger of reviving inflationary expectations. In short, use of short-term fiscal stimulus could well, in the view of these Directors, be

counterproductive. They therefore placed emphasis on the medium-term steadiness of demand management, coupled with vigorous action on the supply side. The latter type of action would help remove structural constraints to faster growth and thereby stimulate private confidence and private spending. In this connection, it is worth noting that all Directors agreed with the importance of dealing decisively with structural rigidities and creating a climate of medium-term stability in policy. The major differences of view therefore revolved around the scope, in present circumstances, for easing demand management policies in those countries where good progress has been made toward a more sustainable financial position.

Prospective developments in industrial countries were viewed as a key element in the environment for the third major topic addressed in the discussion, namely, how to strengthen investment and growth in the developing world. There was general agreement that, with only moderate growth in world trade and subdued commodity prices, the quality of policies in developing countries themselves assumed major importance. It was noted that countries that had maintained competitive exchange rates, while controlling fiscal deficits and mobilizing domestic saving, had generally been more successful in maintaining the momentum of development. Nevertheless, many Directors felt that even with good policies, developing countries would have difficulty in accelerating the growth of investment and output unless the growth of markets in industrial countries accelerated and developing countries' access to these markets improved.

Another aspect of this issue that attracted considerable attention was the role of existing debt in inhibiting new lending from abroad and new investment domestically. The subject of debt will be dealt with more comprehensively in our next Board meeting. I shall therefore mention only a few of the principal points that emerged in our discussion. First, many Directors noted that the staff's analysis implied that capital inflows were unlikely to take place on a voluntary basis so long as existing debt was valued by markets at a considerable discount on its contractual value. Moreover, even domestic investment would be discouraged by the prospect that profits would need to be taxed to service external debt. It was noted that there were two broad categories of indebted countries: on the one hand, those with very large liabilities to official creditors, low per capita incomes, and limited prospects for export diversification; on the other hand, middle-income countries with significant debt-servicing difficulties but reasonable economic prospects in the medium term. For the former group of countries, there was broad agreement that financial assistance on concessional terms would remain essential. The desirability of generosity in the provision of such assistance

was stressed. For the second group, most speakers emphasized the need for a combination of firm adjustment policies and additional financial flows.

The last topic on which I want to comment is international cooperation. Directors were unanimous in underscoring the importance of strengthened international cooperation in today's difficult environment. A point that was made with considerable force was the need to resist protectionist pressures if an open trading system was to be preserved and the debt situation managed on a satisfactory basis. Indeed, protectionism was regarded as perhaps the greatest single threat to sustaining the present upswing. An area that was singled out by several Directors was that of agricultural policies in industrial countries.

Satisfaction was expressed at the intensified commitment among the major industrial countries to coordinate policies. Many speakers followed Mr. de Groote in stressing the important role that the Fund could play in this process: in providing technical support for preparing meetings; through the Managing Director's full participation in discussions of Ministers and Governors; and in helping develop "norms" by which developments in policies and economic performance could be monitored and appraised. Directors felt that the staff paper represented a useful extension of earlier work on indicators, and they encouraged the staff to develop further its analytical framework. In particular, a more quantified analysis of alternative scenarios, based on different assumptions concerning policies and economic conditions, was requested.

Attention was also given to the need for international cooperation in dealing with the debt situation. In this connection, some Directors commented that more attention could have been given in the staff paper to the need for greater flows of concessional lending to the poorest countries. As to the heavily indebted countries' situation, there was general agreement that the management of their external debt is now entering a new and more difficult phase and that all parties will have to recognize their joint responsibility if satisfactory solutions are to be arrived at. Our next discussion will be devoted to a further analysis of the latter issues.

## 2. DEBT STRATEGY - IMPLEMENTATION - CURRENT ISSUES

The Executive Directors considered a staff paper on current issues in the implementation of the debt strategy (EBS/87/38, 2/20/87; and Sup. 1, 3/9/87).

Mr. Ortiz made the following statement:

The staff has provided us with a paper that goes well beyond the treatment of this subject in previous Board discussions in pointing out the shortcomings of the current debt strategy, and in suggesting, albeit cautiously, new courses of action. This is a commendable effort. However, the coverage of the paper is limited to financial aspects, focusing particularly on the present and prospective role of the Fund in this area. The second major area of the debt strategy, the adjustment process and the restoration of economic growth in indebted countries, is not dealt with. Yet, as I will argue, those two aspects are intimately related.

It is well known that the main objectives of the debt strategy implemented since the onset of the debt crisis have been the restoration of normal debtor-creditor relations, which should eventually lead to the resumption of voluntary lending; and the restoration of sustainable economic growth in indebted countries. These objectives were to be achieved by a combination of three basic elements: strong adjustment efforts on the part of indebted countries, aimed both at macroeconomic stabilization and structural reforms; adequate financing from private, official, and multilateral sources; and, very important, a favorable external environment.

I will not attempt a thorough examination of the reasons why the current debt strategy has failed to achieve its objectives. However, in examining the relative contributions of the above-mentioned factors, it would be fair to say that strong adjustment has taken place--surely to a greater degree than envisaged at the onset of the crisis--as evidenced by the dramatic correction of external imbalances that has taken place since 1982. While efforts directed at domestic economic stabilization have been less successful, this is largely due to the fiscal aspects of the debt problem and the often conflicting impact of short-term stabilization policies with the dynamics of debt service--a point I will return to later. However, it seems clear that financial flows have not been forthcoming--and this is a major theme of the paper--and that developments in the external environment have been quite unfavorable after 1984, as reflected in the slowdown of the world economy and international trade and, especially, in the deterioration of the terms of trade for most developing countries.

The staff recognizes the failure of the strategy to restore normal debtor-creditor relations and, moreover, concludes that the prospects for normalization of these relations under current institutional arrangements--particularly with respect to the private creditors--are quite dim. Yet, the staff paper does not address the question of why the strategy has also failed to restore sustainable economic growth in developing countries. Although these two aspects can be treated separately for analytical purposes, it

seems clear that they are intimately related and that the achievement of one objective without the other does not seem feasible, although different interpretations of what "normal" debtor-creditor relations could be in the future are certainly possible.

A general observation that can be made on the shortcomings of the current strategy is that it has not led to a correct identification of the significance of the stock imbalances for the correction of the observed macroeconomic disequilibria. In present circumstances, these disequilibria, such as current account and public sector deficits, represent the "flow" manifestation of stock imbalances. Yet, the ingredients that have been put together to deal with the debt situation, namely, orthodox adjustment programs and concerted financing packages on commercial terms, are focused exclusively on the flow disequilibria, neglecting the stock dimension of the problem.

The strategy pursued would have had a much better chance of succeeding if the external environment had been such that the stock imbalances could have been diluted through flow adjustments. This has not been the case. As several Directors pointed out in the recent discussion on the world economic outlook, the indicators that are most commonly utilized to assess the payment capacity of indebted countries--a factor determining the possibility of regaining creditworthiness--have deteriorated rather than improved since 1982. The debt/export ratios for the 15 largest debtors and for the group of low-income countries have increased by 27 percent and 33 percent, respectively, from 1982 to 1986. We then face the paradoxical situation in which countries are generating large trade surpluses to service their debt, while becoming more insolvent from a balance-sheet perspective. The impact of the stock imbalances on the two basic aspects of the debt strategy--adjustment and finance--has been pervasive and is becoming increasingly evident. The comments that follow address these issues.

How does the magnitude of the stock imbalances--or the debt overhang as it is now called--affect adjustment? The answer to this question is central to explaining why the drastic turnaround of the external deficit of indebted countries has not been accompanied by the correction of internal imbalances and the abatement of inflation. Some countries have generated very substantial trade surpluses yet experience many difficulties in reducing public sector deficits and inflation.

First, for some debtor countries, the "debt overhang" concept must be expanded to include internal debt because the domestic mirror image of the debt crisis is a fiscal crisis, resulting mostly from overborrowing by the public sector in the past. This does not imply, of course, that the debt problem is exclusively a fiscal problem, since it is obvious that there is a real resource transfer involved. But to the extent that debt is owed by public



sectors, they face the additional problem of extracting resources from society to effect the real transfer abroad. The natural tendency for society to resist this extraction by the public sector often gives rise to inflationary pressures and/or capital flight.

Second, adjustment measures adopted to tackle external imbalances--such as exchange rate depreciation and fiscal containment via increases in the prices of goods and services of public enterprises and/or reductions in subsidies--have a direct impact on domestic prices leading to higher inflation. In turn, higher inflation eventually feeds back into fiscal disequilibrium through the Tanzi effect and the payment of higher nominal domestic market rates, giving rise to vicious circles, which by now have become quite familiar in the recent experience of highly indebted countries.

The impact of the debt overhang on adjustment and finance has also become a vicious circle, linking these two aspects of the debt strategy. Finance has been curtailed, as the banks claim that adjustment has been insufficient, but this, in turn, has hampered the efficacy of adjustment efforts. Let me elaborate on this point.

As pointed out in the paper, it has become increasingly difficult to work out concerted financing packages with commercial banks. One explanation for the increasing difficulties experienced in arranging new financing packages is that banks are now a far less cohesive group than they were when the debt problem arose in 1982. Because of different regional interests, country specific regulatory environments, and different capitalization practices, the problem of spreading risks and possible losses has become far more complex. Advisory committees are playing a less effective role, since the banks on the committees represent increasingly diversified groups of banks.

An ostensibly positive aspect of the decreased cohesiveness of the banking community is that it should allow for a wider range of financing arrangements. However, one problem encountered in trying to broaden the range of financial possibilities is that the banks not only face difficulties in reaching agreements with their own customers on the terms and conditions of new financing, but also are increasingly experiencing problems in reaching agreements among themselves as well. This reflects in part decision-making problems typical of "cartel-type" organizations, which have been fostered by the approach adopted by the governments of creditor countries and multilateral institutions. By setting a system of "rewards" and "penalties" in which individual countries must negotiate with groups of creditors, they have, in effect, institutionalized a bank cartel.

But the lack of bank cohesion also reflects a market reality. For some time now, the market has been discounting the value of developing countries' debts, which trade in the secondary market

at values considerably below those originally contracted. And, as Mr. Massé pointed out during the Board discussion on the world economic outlook (EBM/87/47, 3/16/87), it is becoming increasingly evident that the observed wedge between the contractual and the market valuation of existing debt is an important inhibiting factor for the generation of new investment, both in physical and financial assets. Potential issuers of new debt fear that it will fall into the same risk category as the old debt, so that the market would immediately discount it.

This point is clearly illustrated in the recent negotiation of the Mexican debt restructuring package which is due for completion next Friday. The reluctance of several smaller regional and European banks to participate has more to do with the fact that Mexican debt is selling at a discount than with the so-called concessions included in the package, which have been pointed out as the main reason why the package cannot be "sold" by some representatives of large money center banks. The point is really quite straightforward: some banks have actually sold debt at a discount in the secondary market, and others are obviously aware that such discounts exist. Naturally, the prospects of adding a new asset to their portfolios--in the form of new credits--that is being traded at a discount is not very attractive. They also resent the way in which the advisory committees are structured and the form in which burden sharing is allocated but, again, this has to do more with the strains of the cartel mentioned earlier. Paradoxically, the position of the reluctant banks is in some cases closer to the views of borrowing countries themselves. Some banks are not willing to extend new credit on the grounds that adding new debt to the old debt in order to service the old debt is not a viable course of action. They would be much more willing to accept schemes such as interest capitalization or to recognize that the market value of the debt differs from that of the contractual value, and thus to adjust debt service accordingly. However, given the rigidities of the financial package, they are not able to participate in ways other than by extending new credits.

This brings me to the key issues raised in the paper on how to proceed with the debt strategy and what the role of the Fund should be in these circumstances. These issues are intimately related to the differentiation made in the paper on the world economic outlook between countries facing a liquidity problem and those considered to have a solvency problem in the sense that their capacity to service the current levels of debt at contractual terms, even under the most optimistic assumptions regarding external developments and effective adjustment, is very much in doubt.

A first point that can be made in this connection is that it is extremely difficult in many cases to make a distinction a priori between liquidity and solvency situations. The outcome will depend

both on internal adjustment efforts and external developments. But there are other cases, involving mostly low-income producers of primary commodities that are dependent mostly on official finance, in which a more definite assessment of insolvency can be made. For this group of countries, the suggestion contained in the staff report that structural reform programs should be accompanied by long-term concessional finance and, I would add, debt forgiveness seems broadly appropriate. Obviously, the Fund must play an important role in these situations, securing from official creditors adequate conditions for the elimination of the countries' arrears to this institution.

For countries that are not dependent on official finance, mechanisms will have to be established that somehow resolve the present deadlock in bank financing. One possibility, as suggested in the staff report, could be interest capitalization within a framework of debt subordination. The essential point would be to establish a medium- to long-term horizon in which the real resource transfer associated with the old debt would be greatly reduced, while attempts are made to re-establish a normal pattern of operation for new credits between a smaller number of banks and debtor countries. In this context, the Fund can certainly play a useful role, inter alia, by considering and suggesting innovative mechanisms and financial assurances at the onset of arrangements.

A final word on enhanced surveillance. We remain of the view that this procedure, when applied in the appropriate circumstances, can be a useful tool in helping to re-establish a more normal pattern of relations between debtors and creditors. The Fund should engage in enhanced surveillance at the request of member countries, when it is considered that enough progress has been made in the restoration of medium-term balance of payments viability. The procedure should be applied flexibly, both with respect to the detail of the quantified program prepared by the country, and with respect to the monitoring and evaluation of these programs. We also agree with the practice of omitting references to views expressed by Executive Directors, as well as the names of the staff involved in staff reports prepared for countries involved in an enhanced surveillance arrangement.

Mr. Ismael made the following statement:

This chair shares very much the concern of the staff paper that normal debtor-creditor relations have yet to be resumed on a basis that can assure an adequate flow of external financing to sustain adjustment with growth in the indebted countries. Indeed, both "debtor fatigue" and creditor bank reticence had been threatening to reach dangerous levels until Brazil's moratorium on bank debt servicing imparted a renewed impetus to the conclusion of

financing packages on terms that are more acceptable to the debtor countries. I hope the banks' new attitude will last, but we cannot be too optimistic.

I can agree with the staff's assessment that the achievement of the objective of spontaneous commercial financing is likely to be a more protracted and more difficult process than originally expected. Achievement of this objective requires the careful orchestration, perhaps over a prolonged period, of many diverse developments that could be difficult to manage: a favorable global economic and financial environment, increased flows of concessional financing, sustained adjustment with durable growth in debtor countries, a central role for the multilateral institutions in terms of adequate financing and sound policy advice, and a lasting restoration of private bank confidence to resume lending at adequate levels. The importance of each of these elements and their close links with one another are well known, but I am glad the staff reminded us again that the debt strategy must be seen in a wider context.

I propose to comment briefly on some of the other elements of the debt strategy before I focus on the Fund's relations with creditors. The key role of policies in the industrial countries to the debt strategy cannot be overemphasized, especially the strong support that can be provided by increased access for developing country exports, low and stable interest rates, and reduced protectionism in agriculture. Microeconomic policies in a few areas also deserve prompt attention.

First, official creditors in the industrial countries can do much more to contribute to the success of the debt strategy. The Paris Club has been too strict, and perhaps too rigid, in terms of the maximum maturity provided for rescheduled loans and the commercial rates charged. I agree with the staff that it is inappropriate to reschedule concessional aid on commercial terms. An easing of such terms should complement increased concessional flows.

Second, the accounting, tax, and regulatory framework in industrial countries can be made more similar across countries to promote increased cohesion among banks, especially with regard to provisioning and the acceptance of new instruments, such as interest capitalization and the investment notes of the Philippines. The Fund can usefully look into this area with the aim of promoting greater uniformity.

Third, official creditors currently not participating in the Paris Club need to be part of that multilateral framework for rescheduling official debt. I wonder whether the Fund can use its influence to persuade these parties to participate.

In the case of the debtor countries, I agree with the staff that convincing action must continue to be taken to strengthen their economies for durable growth with reduced external imbalances, greater inflows of foreign investment, and increased domestic savings. However, the debtor countries need stronger incentives to persevere in their efforts. As the Managing Director said in the recent symposium on growth oriented adjustment programs, "growth is just as necessary to sustain adjustment as adjustment is to sustain growth."

In addition to the points raised in this staff paper and elsewhere, I would like to highlight several issues. First, the World Bank can do much more to ensure the quality of adjustment by promoting projects that increase exports, domestic savings, and economic efficiency in debtor countries. Second, these efforts must be supported by increased concessional flows, especially to the low-income countries. This chair hopes that the structural adjustment facility will provide the focus for a much larger flow of concessional financing than has been forthcoming so far. Third, concerted action should be taken to increase the global demand for commodities or, at the least, to avoid undermining the adjustment efforts of developing countries through the introduction of new protectionist measures, as in the case of the proposed EC import levy on oil and fats.

In the area of debtor-creditor relations, I do not see much room for the Fund to reduce its important role. Although the Fund should try to reduce over time its lynchpin role in guiding private and official flows to developing countries, it cannot escape its responsibility in overseeing the implementation of the strengthened debt strategy, or in guarding against the systemic failure of the international financial system. Hence, I would agree with the staff paper that the Fund needs to continue in some cases to provide further financing from its own resources and to help mobilize concerted financing. The Fund may sometimes need to be more forthright than it has been in committing its own resources. Although the Fund clearly has a responsibility to protect its resources, its recent insistence on providing financing only when a critical mass of commercial bank financing had been mobilized might have contributed to the present deadlock in the flow of financing to debtor countries. There is a need for the Fund to move away from a too rigid and legalistic interpretation of the rules, as in the case of a recent request for compensatory financing. I would therefore prefer that, where appropriate, the adequacy of commercial bank financing should be determined at the time of a review during an arrangement rather than at the outset.

As regards other issues raised in the paper, I support the close cooperation of the staff with other parties in the debt strategy to facilitate agreements that are flexible and yet provide adequate assurances to banks, as well as to encourage a

further "de-linking" with Fund arrangements in the cases mentioned. I also support the staff recommendations on enhanced surveillance. I think one statement on page 30 of the staff paper aptly sums up the approach that the Fund should adopt: "The Fund will need to be imaginative in the forms of its involvement, and respond in exceptional ways to exceptional efforts by debtor countries and by creditors." However, I do not favor any "bailing out" of the banks with public funds.

Continuing in this vein, I wonder whether the Fund should explore more fully some innovative ideas for strengthening the implementation of the debt strategy. A number of ideas were presented in the recent symposium on growth-oriented adjustment programs. First, concessional rescheduling, or even write-offs, of private and official debt in selected cases, especially where the banks have already made ample provisioning, should be considered. The fear of contagion effects can be reduced if all parties involved trust the Fund to prepare a list of eligible countries with the consent of the authorities concerned. After all, the international community made exceptional efforts on the basis of the Fund's list of countries that were "most seriously affected" by the first oil shock, and those that were eligible Trust Fund recipients and beneficiaries of the structural adjustment facility. Second, "seniority" could be accorded to new debt, so that lenders need not fear that new loans would be reduced immediately to the market valuation of existing debt. Such a concept is already implicit in the Paris Club reschedulings and in certain cases of commercial bank reschedulings. Third, the wider development of a secondary market for existing debt, without affecting the book value of remaining debt, should be explored.

Agreement on these matters will be difficult, and they need to be approached with extreme caution to avoid giving wrong signals to the market. But they need to be explored at a technical level to determine whether they can contribute to the debt strategy in a manner that is both sustainable and market related.

Mr. Massé made the following statement:

I will begin by suggesting some improvements within the context of the current debt strategy. In the second part of my comments I intend to present some more theoretical views on the debt strategy, which might influence our choice of longer-term solutions.

Recent difficulties in mustering commercial bank support for concerted financing packages have at times directly threatened the implementation of Fund-supported programs. In cases where the Fund has made the achievement of a critical mass of commercial bank financing a precondition for Fund-supported arrangements to

go into effect, there has been increasing difficulty in reaching agreement between debtors and bank advisory committees. And where agreement has been reached, it has also proved difficult in some cases to obtain the critical mass. Furthermore, there may still be important delays in actual bank disbursements. In view of these difficulties, my authorities believe that the Fund will have to consider even more flexibility in the degree and timing of assurances required for bank financing, reflecting the particular circumstances in each case. Also, Executive Board approval has an important role to play in sending signals of support for adjustment efforts. And, in this regard, approval in principle can be a useful instrument.

However, it is clear that the issue of bank cohesion has emerged as a major impediment to obtaining the necessary degree of bank participation over a reasonable time period. Cohesion has been influenced, inter alia, by the relative exposures of banks, different levels of provisioning, and varying national regulatory practices. The two major options noted by the staff for ameliorating this problem--reducing the number of banks in a financing package, particularly those with small exposures, and allowing alternative instruments for burden sharing among banks--appear useful, although numerous practical difficulties in implementing such schemes can exist, and, in our view, the banks themselves would have to initiate the implementation of such schemes.

Another recent problem is that banks have sought increased leverage over the scale of contributions of the official community, and have tightened their own conditions in terms of performance under Fund and Bank arrangements. My authorities feel strongly that the linkages sometimes established between bank financing and Fund conditionality may be inappropriate. Also, bank disbursements can be excessively tied to Fund and World Bank programs in an overly mechanical way. For these reasons, it is desirable that the staff work closely with members, banks, and the World Bank to provide adequate policy assurances to the banks that are not overly rigid and do not risk disbursement delays.

My authorities welcome the innovations appearing in some recent debt rescheduling agreements, including options for relending or onlending, the conversion of debt into equity, and options to convert floating rate debt into fixed interest rate debt. Also, we are supportive of the market-oriented solutions that have appeared, particularly in the context of the secondary market for developing country debt and debt-equity conversion schemes. Debt-equity conversion schemes can contribute to a reduction, although on a relatively small scale, in debt service payments, and may provide an important route for banks with small exposures to withdraw from future financing packages. I would agree, however, that the monetary, fiscal, and net investment impact of the debt-equity schemes is not always easily defined and will be dependent upon

the particular circumstances of each country and the specific regulations governing each scheme. Therefore, while I would encourage such approaches, further study, particularly of their net economic impact, would be helpful.

Official creditors also have a role to play in the debt strategy. The Paris Club has recently discussed the possibility of reducing contractual interest rates on the debt of the least developed countries, which could provide significant concessional relief. The structural adjustment facility might also be used more extensively to coordinate donor assistance and debt relief. I note that the Paris Club is prepared to consider on a case-by-case basis rescheduling in the context of an arrangement under the structural adjustment facility without a stand-by arrangement being in place. This is a sign of flexibility and would allow the Paris Club to adopt a more medium-term focus.

In closing this part of my comments, I would like to point out that actual disbursements by official creditors of quick-disbursing concessional resources to certain low-income countries have fallen significantly short of commitments, suggesting that better planning and improved procedures are required. In this regard, the increasing use by bilateral creditors of aid coordination groups, including the World Bank's consultative group process, is a positive development. I strongly endorse the proposition that the magnitude of the debt problem in low-income countries suggests that the question of greatly increased concessional assistance may have to be addressed by official creditors.

I would now like to turn to the second part of my remarks which are of a somewhat more theoretical nature. It seems to me that an important factor in the recent decrease in external financing and new investment is the effect of what a number of observers have referred to as the debt overhang. Very briefly, there are two main lines of thought in this analysis. First, since the authorities of the debtor country are committed to taxing incomes and/or inputs in order to service the existing debt, there is a corresponding decrease in the expected rate of return on new investment, which depresses investment and contributes to the rate of the market discount on existing debt. Second, since there is no means by which a new investor can convincingly differentiate his claim from existing claims, it follows that potential investors must assume that the market value of their new claims will become immediately equal to the value of existing old claims. Therefore, there is an immediate capital loss on new investment that is indicated by the market discount on existing claims. And, clearly, in those cases where the capital loss is seen to exceed the expected return on new investment opportunities, there will not be new investment. Some evidence for this view has been provided by Canadian commercial banks in meetings with officials from Canada's Department of Finance: the banks have emphasized



that because each dollar of new lending to Mexico has an immediate value in the secondary market of only about \$0.70, their participation in new money packages has been extremely difficult to sell to their shareholders because it means an immediate loss. However, I would like to stress that one needs to interpret the market discount carefully, as it is dependent, or contingent, upon a large array of variables, including agents' expectations and regulatory practices.

To the extent that the debt overhang and debt service undermine investment and growth prospects, the debtors' willingness and ability to continue the adjustment process and to service debt will diminish, putting at even greater risk the banks' portfolios and the debtors' growth prospects. That is, debtors have a continuing incentive to adjust and to service debt only if some minimal level of investment can be maintained. At some point, the burden of the debt overhang can undermine this incentive and the debtors' ability to put in place the necessary policies. Therefore, at some point, creditors should also have an incentive to agree to restructure or reduce the debt in order to increase the probability of successful servicing of remaining debt.

Our analysis must also include a greater appreciation of the consideration of the fundamental uncertainty surrounding the debt situation. As some authors have argued, a useful way to think about the debt problem is in terms of a model or framework in which the eventual solvency of the debtor is uncertain. With respect to the debt service, the relevant variable is the potential resource transfer that the country is able and willing to make, which is a function of, inter alia, exogenous shocks, the incentives provided by the debt strategy, and the benefits yielded by the adjustment process. It is important to realize that there is a degree of uncertainty associated with each of these factors, particularly with the role of exogenous shocks and the external environment. The question we face then is how to behave, given this uncertainty.

On the one hand, actions could be based on expectations of favorable exogenous shocks and rapid adjustment benefits, with the risk that the consequences may not be managed satisfactorily if these expectations were not realized. It seems reasonable to argue that, to some degree, this state characterizes our present situation. On the other hand, if the debtor perceives that debt service cannot continue satisfactorily except in unlikely circumstances, there may be little incentive for the debtor to continue the adjustment process. Assuming the expectation of unfavorable results, debt write-downs could be pursued, the risk being, for lenders, that these write-downs could turn out to be, ex post, unnecessary.

Between these extreme cases is the design of a strategy where the level of payments, and whether the debt is fully paid, depends on the actual situation that will prevail in future, that is, where payment is linked to an "ability to pay," which is a function both of exogenous shocks and the adjustment effort, or where payment is tied more precisely to developments in the external environment--the price of oil or of some other main commodity. As an interesting conceptual example, we might consider a strategy that attempts to maximize debtors' incentives to adjust by letting relatively more of the adjustment benefits accrue to the debtor, while allowing creditors to take relatively greater advantage of exogenous positive shocks, such as an increase in the price of oil for an oil producing developing country with exogenous negative shocks being shared to some degree between debtors and creditors.

These considerations--the effect and meaning of the debt overhang, the need to satisfy competing incentives and objectives, and the role of uncertainty in the debt problem--seem to be inter-related. It would be helpful for the staff to study these aspects to determine their relevance, how we might respond, and whether the strategy we have outlined has, in practice, any chance of satisfying enough of the needs of the debtors and creditors to succeed. I would like to stress, however, that none of these remarks should be taken to suggest a diminished role for the sort of macroeconomic and structural policies advocated by the Fund or for conditionality. As has been made abundantly clear by experience, the need for sound policy is a necessary condition to a resolution of the debt problem. My main interest at this stage is to encourage increased and more rigorous analysis of these issues that could lead to some new solutions.

Ms. Bush made the following statement:

The present discussion provides a useful opportunity for us to examine the progress that has been made in implementing the debt strategy and to think further about the evolution of that strategy. Many issues are raised in the staff paper; I will focus primarily on the specific questions and issues raised by staff, and will make some general comments on progress to date under the strengthened debt strategy. While the staff paper also provides a comprehensive history of developments in the debt situation in 1982 and thereafter, it is important at this juncture that we focus on the issues surrounding the current strategy.

The strengthened debt strategy was based on the fundamental need for strong sustained growth in debtor countries. That continues to be the focal point, with the supporting elements of the implementation of growth-oriented policy reforms by debtor nations and the provision of adequate capital flows. Of course, some questions have arisen about the debt strategy, such as those mentioned

in the staff paper. As we consider the strategy in light of these questions, it should be recognized that the strengthened debt strategy is a dynamic framework within which new ideas and refinements can and should be developed. We believe that the case-by-case approach allows for such refinements and new ideas.

As was discussed at the recent Board meetings on the world economic outlook, a growing world economy with open markets is of critical importance to all nations, especially to indebted nations; my authorities will continue to make efforts to contribute to the achievement and maintenance of such an environment. Through our consultations and coordination with other industrial countries, such as that in Paris last month, we are making efforts to promote non-inflationary economic expansion and to resist protectionism. It is important that the major industrial countries continue along these lines and build on the progress that has been made so far in the area of policy coordination. It is worth reiterating the point we stressed at the world economic outlook discussion that it is critical that there be prompt follow-through on the undertakings agreed on at the Paris meeting, and that all industrial, as well as developing, countries do their part to ensure an expanding and open world economy.

Central to the debt strategy is the emerging change in debtor country attitudes and economic policies, particularly with regard to the increasing attention being given to prudent financial policies and structural reforms. It is encouraging that increased attention is being paid to these important aspects of economic adjustment and that progress is being made. Some debtor countries have made substantial strides in putting important market-oriented reforms in place. Progress in the areas of trade liberalization, reduced barriers to direct investment, tax reform, and privatization of some public sector enterprises are clear in a number of cases. For example, in Mexico, the Philippines, Nigeria, Morocco, and Côte d'Ivoire there has been progress in a number of these areas. Despite these steps forward, there is still much to be accomplished, and we continue to emphasize those policies and economic reforms that increase the scope of market forces, reduce domestic distortions, and encourage domestic investment. We believe that the implementation of such reforms may already have contributed to more favorable expectations for positive real economic growth for developing countries this year and in the medium term. We also believe that these reforms can lead to an expansion of non-debt creating capital inflows to indebted countries, including a higher level of foreign direct investment and capital flight repatriation.

In relation to this issue of necessary policy reforms, I am concerned about the emphasis that has been given here today to the concept of debt overhang. Certainly, adequate levels and forms of financing for debtors are critical to sustaining investment and

growth. However, as Mr. Dallara said at EBM/87/47, we found the concept of debt overhang to be unhelpful and potentially misleading, as it could divert attention away from the need for sound policies and away from the need to mobilize new financing for debtor countries. Another concept that was mentioned in the staff papers on the world economic outlook, along with debt overhang, was "the lack of an appropriate international mechanism for writing down the book value of debt to a level more reflective of its market value." We also found this notion to be troublesome and unhelpful because prices determined in the secondary markets for debt reflect numerous operating imperfections and a lack of market depth. Accordingly, we are not convinced that the secondary market that has developed is truly reflective of the underlying value of that debt.

Returning to the debt strategy, debtor country policy reforms have received the strong constructive support of the Fund and World Bank, with the two institutions committing nearly \$12 billion in new loans to the major debtors since the 1985 Annual Meetings in Seoul. The World Bank has expanded the scope of its policy-based lending, and is therefore providing strong financial support to those structural adjustment efforts that are critical to the restoration of sustained growth. Progress on the third leg of the strategy, commercial bank lending, has developed at a slower pace and it is, therefore, important that we are focusing on that leg of the strategy today in some detail.

A great deal of attention is given in the staff paper to the role of commercial bank financing in the strengthened debt strategy. Clearly, commercial banks have responded to some degree--there have been supportive new lending commitments for Mexico, Nigeria, Ecuador, and Uruguay, totaling some \$8.3 billion, as well as a retiming arrangement for Chile that yielded \$400-\$450 million of savings over a two-year period. In addition, since October 1985, commercial banks have rescheduled about \$68 billion of debt maturities related to obligations of most of the major debtors. However, we agree that commercial bank efforts have not been adequate to date and that there is more that the commercial banks can and should be doing to facilitate the completion of new money packages and debt reschedulings. Many of the ideas put forth in the staff paper center around possibilities for new modalities; this is an important area, and the banks will surely need to take the initiative themselves in developing new modalities.

In particular, it would appear useful for the commercial banks to develop a menu of options, among which banks can choose, in order to maintain broad bank participation in new financing packages. Several different specific techniques might be included in such a menu. At the same time, it will be important to assure that the total amount of financing needed is provided and that equity in burden sharing is assured among the banks. Difficulties

may arise in reconciling a broader diversity of types of financing with the need for fairly allocating new money shares. But I believe that greater flexibility in devising new money packages is essential if future bank syndications are to be successful. Our case-by-case approach calls for the banks to be willing to develop and try new techniques, and for flexibility in modifying approaches in response to actual experience. Indeed, it would be in the commercial banks' own interest for them to take the lead in developing new modalities that can help assure that the concerted lending process works.

For instance, there may be a common interest on the part of debtors and commercial banks in limiting total debt burdens, which could imply repricing, retiming, or rescheduling agreements in some cases as alternatives to new loans. We must recognize, however, that some of these alternatives involve only a one-time gain. Nevertheless, there are benefits to such approaches and some can be easier to achieve than new money packages. Of course, there will continue to be a need for new lending to many debtors, and the negotiations on new money packages should be expedited by debtors and creditors alike.

The development of various options would go far toward addressing the bank cohesion issue that is discussed in the staff paper, as I believe that cohesiveness and participation rates will be enhanced if individual banks find that they can participate in financing packages through means that take into account their individual circumstances. Specific forms of alternative means of financing should be developed by the banks themselves. And, of course, there is room for innovative thinking in this area by various parties, including perhaps the Fund on an informal basis. However, I must caution against concentrating on a formalized structure or a uniform and rigid approach to all debtors. Flexibility remains critical if debtors and commercial banks are to resolve these issues in an equitable fashion.

I must not neglect mentioning one recent innovative idea that has been put forward by the Philippine Government--the PINS, or Philippine Investment Notes. This approach is certainly innovative and merits serious consideration.

That brings me to the general issue of debt-equity swaps, which is one attractive alternative described in the staff paper. Conversions of debt into equity can help reduce outstanding debt and annual debt service burdens. The discounts that have emerged on some debt paper, coupled with attractive rates for converting foreign exchange into local currency can encourage equity investment flows over and above those which would otherwise have taken place. There are a number of additional advantages over and above the heightened potential for equity investment. By improving the debt-equity mix of a country's external liabilities, exposure to

variations in global interest rates can be reduced. Also, debt-equity mechanisms frequently are accompanied by some liberalization of the investment climate, which supports the broader objective of making debtor countries' investment climates more attractive to foreign investors in general. Furthermore, in those countries where the foreign exchange for conversions comes from residents of the debtor nations themselves, swaps can serve as a mechanism for the repatriation of flight capital, the least costly source of foreign capital. Finally, commercial banks that participate in such swaps reduce their own total exposure.

The success of such schemes will also depend on their specific features, such as the freedom to invest in various economic sectors, liberal treatment of repatriation of earnings, and so on. While swaps alone cannot solve the debt problem, they can make a very useful contribution to reducing both debt and the debt service burdens and also to increasing production and employment opportunities, if debt is converted into equity in productive areas. The International Finance Corporation (IFC) can play an important role in encouraging such equity inflows in the years ahead. Its national investment trust concept, together with mutual funds and debt-equity conversion funds that are being created by the IFC and by some private financial institutions, can also be important in this effort.

In sum, while the contributions of debt-equity swaps to the relief of the debt problem may be small at present compared with the size of the problem, I believe that the use of this mechanism will grow, and that this mechanism presages the development of other creative solutions, which when taken together can eventually make a substantial contribution to greater cooperation and normalization of debtor-creditor relations.

The possibility of interest capitalization is explored in the paper. While it may be viewed as attractive to some, this approach continues to be somewhat problematic, given the variations in regulatory environments, accounting practices, and reserve practices in various countries.

The quest by some creditor banks for extensive World Bank guarantees of their lending is not likely to be productive and is also very problematic. While perhaps some very modest role might be possible in some circumstances, it is problematic to consider widespread use of this mechanism. In fact, such guarantees might delay a restoration of spontaneous lending. Commercial banks might consider, instead, in this menu approach to new money, increased trade credits, project lending, cofinancing, and floating rate notes and bonds, all of which can result in new money flows. Countries might also consider borrowing more frequently,

but in smaller amounts, and banks could give greater consideration to more innovative and flexible terms for debt restructurings, such as repricing and retiming options.

I will comment on some of the specific modalities that were mentioned in the staff report regarding the Fund's role. However, I also believe it important to re-emphasize that the Fund's primary role is to provide sound and credible policy advice to its members and modest, temporary balance of payments financing that would help in catalyzing other financial flows. This was certainly the role that the Fund played in a way that was most helpful in the difficult debt situation of 1982, and it continues to be its role today. It is also important that the Fund give further emphasis to the types of structural and market-oriented policies that were envisaged by the strengthened debt strategy. This suggests that there is a stronger role to be played by the Fund in the debt strategy by adapting conditionality under Fund programs so that conditionality encompasses and gives emphasis to the market reforms that are necessary for growth-oriented adjustment. This is a key part of the Fund's role. I must also add that in order for the Fund to continue to play a credible role in the debt strategy, its own financial position must be sound. This means that the arrears situation that we are experiencing must be firmly addressed, that there must be proper recognition of the problem in our financial reporting, and that the Fund's financial position must be appropriately strengthened in view of this problem.

The staff has raised a number of issues related to the achievement of adequate levels of financial support from various sources and the role of the Fund in that process. That role can sometimes require a delicate balancing, especially when the Fund is confronted with the issue of how it can best facilitate the mobilization of a financing package without interfering in the interbank coordination process. In its paper (EBS/87/38), the staff mentions some of the considerations that might be applied in making decisions on these matters. We agree that different factors should carry different weights, depending upon the individual circumstances of the debtor and upon factors affecting relations and negotiations with creditor banks. This suggests that the manner in which the Fund utilizes its procedures to help facilitate the arrangement of financing packages, and the nature of assurances that the Fund will need to go forward with various types of Fund arrangements, will, of necessity, vary case by case. The Fund should retain its flexibility. However, some further staff thinking is probably warranted on how Fund procedures can be best utilized for the benefit of each member on a case-by-case basis, while protecting the Fund's integrity and the revolving character of its resources. Continued use of the critical mass mechanism will be helpful in determining Board action. In sum, pending further evolution of commercial bank efforts, we do not

see major changes in the manner in which the Fund has conducted its relations with members and creditors. However, we do believe it important that the Fund maintain flexibility.

With regard to official creditors, coordination is in many cases much easier, although we have seen several examples of shortfalls in external financing contributing to deviations from expected program performance. The Paris Club has been quite flexible in its official debt rescheduling. Also, we are attempting to improve coordination of U.S. bilateral assistance with that of the Fund and the multilateral development banks, especially through the implementation of adjustment programs under the structural adjustment facility in those countries most dependent on bilateral aid. Furthermore, the United States is making efforts, in selected cases, to better tailor its assistance to the needs of debtor countries. In addition, the Paris Club has recently agreed to consider on a case-by-case basis rescheduling for countries seeking only arrangements under the structural adjustment facility and not upper credit tranche stand-by arrangements. This will enable those few low-income debtors to benefit from the catalytic effect of Fund support without unduly increasing their debt burdens with high levels of ordinary use of Fund credit. In addition to these efforts, higher levels of donor and World Bank support will be necessary to increase the probability of success of the official and multilateral efforts that are under way. This brings me to issues related to linkages between policy reforms and various sources of financing, in particular the issues of cross-conditionality and comparability of financial assistance, which have sometimes been embodied in commercial bank arrangements with debtors. It is logical for the banks to seek some assurance with regard to debtor countries' economic performance that is being monitored by the Fund and the World Bank. But, some serious difficulties have risen when such ties have become too rigid, resulting in delays or even the suspension of commercial bank financial support of adjustment programs which were basically on track. Perhaps the Fund staff could work informally with the commercial banks to devise some less rigid arrangements to accommodate the banks' needs, so as to avoid the danger of an interruption in financial support.

The paper suggested the need for flexibility in the terms of official debt rescheduling, even including concessional interest rates. This is a difficult and complex issue. For example, the U.S. authorities are constrained by legal requirements, especially with regard to rescheduling commercially based credits on concessional terms. Nevertheless, as I indicated earlier, we are making efforts to tailor the terms of our assistance more to the circumstances of the debtors.



We are not attracted to the idea of official creditors relaxing their insistence on a Fund program, or at least enhanced surveillance, as a basis for official debt rescheduling. We also do not see any justification for a general relaxation of the criteria now being used to determine to which countries official multiyear rescheduling arrangements should be extended. And, we believe that the selective use of enhanced surveillance remains justified in some official debt rescheduling cases.

We are still at an early stage of use of the enhanced surveillance procedure. We continue to believe that this is a very useful procedure that can be employed by the Fund, at a member's request, to facilitate debtor-creditor arrangements. As we critique this procedure, it is important to distinguish in a given case, between the procedure itself, and the success of the member in implementing the policies envisioned by the enhanced surveillance arrangement. Success by a given member in policy implementation should generally lead to positive economic outcomes, permitting the transmittal of a positive economic assessment of performance to creditors and a generally successful enhanced surveillance arrangement. However, if policies are not implemented as envisioned, the effectiveness of the enhanced surveillance arrangement could be endangered and alternative courses of action might need to be considered. Even in cases such as these, the procedure of enhanced surveillance will have served the useful purpose of focusing the attention of all involved on the need for quick, remedial action.

Furthermore, the staff paper makes the central point that unless effective leverage is exercised by creditors, enhanced surveillance procedures will not necessarily result in the adoption of appropriate adjustment policies. But, we continue to believe that to be effective enhanced surveillance programs should embody policies that have been agreed by the member and the Fund through a process of consultation and that remaining differences should be clearly identified. Furthermore, the use of quantified targets is essential to success, as they permit creditors a more transparent evaluation of performance and can be central to providing early signals of the possible need for additional corrective action or even of the need to return to a formal stand-by arrangement. Of course, it remains the responsibility of creditors to consider the Fund's evaluation of a country's policies and performance and then to make their own decisions based upon that evaluation.

With this critical function in mind, we found the staff's consideration of the issue of termination of enhanced surveillance arrangements to be somewhat unsatisfactory. This is particularly true with regard to the implication that the Fund is rather rigidly bound by these arrangements, even in cases where their effectiveness is being called into question. In such cases, one could also generally expect that creditors will be experiencing

dissatisfaction with the current arrangement, and will be considering appropriate alternatives. Once again, however, this points to the usefulness of the vehicle in giving creditors a framework within which to act--the same framework that helped the debtor originally to obtain needed debt relief. In the use of enhanced surveillance, the Fund's credibility is on the line, and it is therefore important that we develop current and detailed procedures to assist countries in taking action on policy reforms that will enhance the chances for the success of such arrangements. This is important to all parties involved--the Fund, the member, and creditors.

In conclusion, we believe that progress has been made in implementing the strengthened debt strategy. But obviously there is much yet to be accomplished. It is important that debtor nations continue along the path of structural and macroeconomic reform that emphasize market mechanisms and growth. Commercial banks must step up their efforts and must focus their attention on creating a variety of methods of participating in financing packages that will enhance the chances for success of such packages by increasing the willingness of banks to participate; and new lending must increase to finance adjustment efforts adequately. Clearly, we have not yet returned to a situation of across-the-board spontaneous lending, although of course there is some differentiation by country, depending upon how successful countries are in implementing appropriate policies. As concerted lending and coordination among all parties will continue to be necessary, the Fund will have to continue to play a central role in the debt strategy during the foreseeable future. As I said earlier, the debt strategy is a dynamic framework that can benefit from further refinements and new ideas. However, in evaluating new proposals, we must be very careful to take into account all of the possible consequences on the debt strategy and on the continued ability of debtors and creditors to work together in addressing the problems. In particular, it is crucial that such proposals do not relieve debtors and creditors of their responsibilities. Therefore, we encourage all involved to continue their efforts to support and refine constructively the current debt strategy.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/87/47 (3/16/87) and EBM/87/48 (3/17/87).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/49 (3/13/87) is approved.

APPROVED: October 16, 1987

LEO VAN HOUTVEN  
Secretary

