DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/89/79

CONFIDENTIAL

April 20, 1989

To: Members of the Executive Board

From: The Acting Secretary

Subject: The Fund's Policy on Financing Assurances

There is attached for consideration by Executive Directors a paper on the Fund's policy on financing assurances which will be discussed during the Executive Board meeting scheduled for Wednesday, May 10, 1989.

Mr. Brau (ext. 7854) or Mr. Allen (ext. 8381) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

The Fund's Policy on Financing Assurances

Prepared by the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by L.A. Whittome

April 20, 1989

Contents

I. Introduction

Recent developments in arranging financing packages in the context of Fund-supported adjustment programs in a number of indebted developing countries, the increasing difficulty in concluding many negotiations between countries and their commercial bank creditors in a timely fashion, and the incorporation of more debt-reduction elements in the menu, have led Executive Directors to consider ways in which the effectiveness of the Fund's policy on financing assurances could be improved. The present paper reviews policies in this area, especially in light of the discussions of the Interim Committee in April on the debt strategy, and suggests adaptations needed in current circumstances. 1/

II. The Fund's Financing Assurances Policy in a Changing World Environment

With the emergence of debt-servicing problems as a key element of countries' balance of payments difficulties in the late 1970s and very early 1980s, it became clear that the success of Fund-supported adjustment programs was increasingly dependent on concerted actions being taken by creditors and donors, in addition to the support being given by the Fund and the actions of the country itself. Fund-supported programs had to assume certain actions by the various creditor groups, either concerning the extent and form of debt rescheduling or the amount of fresh financial support to be given by each group. The policy on financing assurances arose out of the need of the Fund and of the member country to have confidence that the assumptions about the actions of other creditors and agents would actually be realized; and of the need of creditors to be satisfied that an adequate sharing of responsibilities was envisaged.

When a rescheduling of a country's obligations to official creditors was assumed, the Fund has normally felt sufficiently confident to engage its own resources before creditors met in the Paris Club. This was because it could be assumed that the coverage of a rescheduling would be consistent with the normal practices of the Paris Club. In the event, official creditors have normally required a Fund program to be in place before they would formally consider a rescheduling. In cases where the coverage of the debt rescheduling went well beyond previous practice and where there was doubt whether the Paris Club creditors would indeed grant a rescheduling on those terms, the Fund on occasion resorted to approval in principle of the arrangement, with its entry into effect following the conclusion of the multilateral rescheduling exercise. However, this procedure has become increasingly rare given the

---

1/ For a detailed discussion of the Fund's policy and practice of financing assurances up to end-1987, see "Financing Assurances in Fund-Supported Programs" (EBS/87/266, 12/14/87).

staff's frequent, informal contacts with the Paris Club secretariat, which have greatly reduced the likelihood of surprises on either side. 1/

When a rescheduling of commercial bank debt was sought, Board consideration of an arrangement was usually delayed either until the commercial bank advisory committee had reached agreement with the country on the terms of the rescheduling or until there was some confirmation that the negotiation process between a country and its creditor banks had progressed sufficiently far that its completion could be confidently expected. Since experience showed that there was a good probability that all bank creditors would eventually agree to a rescheduling of amortization payments if this were recommended by the advisory committee, the Fund generally considered this approach as sufficient to justify the engagement of its own resources.

When programs assumed the commitment of new money by creditors, in addition to amounts that could be assumed to be provided spontaneously, the issue of financing assurances became more acute. Programs have frequently assumed certain flows from the multilateral development banks, in particular the World Bank, and the staff has normally been able to obtain reasonable confirmation that these would indeed be forthcoming before putting a program to the Executive Board. Programs have also often assumed additional assistance from other official multilateral and bilateral sources. In these circumstances, understandings have been sought with the creditors involved before the approval of the program. This has been facilitated by informal contacts with Executive Directors. Some programs have also assumed the reopening of cover by export credit agencies, though this has proved difficult to quantify. Nevertheless, the staff has built up informal contacts with such agencies and, in some cases, sought clear indications of the agencies' intentions regarding the reopening of cover on or shortly after the approval of an arrangement.

After 1982, the sharp decline in the flow of spontaneous finance from private creditors to developing countries with debt-servicing problems, made it necessary for many programs to assume and be based on the provision of new money on a concerted basis from the commercial banks. The concerted financing approach required an adaptation of the Fund's policy on financing assurances. The degree of uncertainty associated with the commitment of concerted financing needed to fill an ex-ante financing gap was such that an agreement by the advisory committee on a term sheet was not normally thought to provide sufficient assurance to the Fund that the envisaged resources would be forthcoming and the financing gap closed. The Fund had therefore to reconsider its approach.

1/ For the evolution of the Fund's approval in principle procedures see "Approval in Principle of Fund Arrangements" (SM/84/217, 9/25/84) and "Financing Assurances in Fund-Supported Programs" (EBS/87/266, 12/14/87), pp. 7-9.

One option would have been to wait until the agreement providing the envisaged resources was actually signed by the banks involved. However, given the number of banks involved, this ran the risk that the process would be so prolonged that the Fund's support to the country would be excessively delayed. As a compromise, the policy of a "critical mass" was developed. A Fund arrangement was generally not presented to the Board until a "critical mass" of support from banks was obtained. The "critical mass" was considered to be that level of participation that made the implementation of the package virtually certain. Precisely what share of the banks constituted a "critical mass" was a matter of judgment on a case-by-case basis.

In the years immediately following the onset of the debt crisis, the "critical mass" approach worked reasonably well; the consent of a large majority of commercial banks to financing packages including concerted lending was obtained relatively easily. However, even in those early years, there were many instances where Fund-supported arrangements became effective before a critical mass was obtained. 1/ The reasons reflected the particular circumstances of each case and always involved some elements of judgment; one consideration that was often crucial in deciding that a deviation from the critical mass approach was justified was that the implementation of a country's adjustment effort should not be delayed. When the Executive Board discussed "Financing Assurances in Fund-Supported Programs" in early 1988, there was agreement on "the importance of prior consultations with Executive Directors before a formal request was put to the Board for use of Fund resources that would not be consistent with the established policies on financing assurances." 2/

During the last 18 months, the reasons that had already led to deviations from the critical mass approach in earlier years, have become more important and widespread. The increasing diversity of views and interests within the banking community, the strengthening of bank balance sheets over the last five years, and the broadening of the menu approach, have made the process of reaching agreement with the banks on suitable restructuring and financing packages more complex and much more time-consuming; moreover, with the proliferation of menu items, it has

---

1/ EBS/87/266 noted that during 1982-87 a critical mass was obtained in about half the cases (fourteen) prior to Executive Board approval. In five additional cases, arrangements approved by the Board in principle became effective when a critical mass had been obtained. In six further cases, the Fund relied on agreement in principle between the country and the bank advisory committee while in the remaining five cases, the Executive Board approved the entry into effect of the programs while discussions between the countries concerned and the banks were still in progress.

2/ See "The Acting Chairman's Remarks at the Conclusion of the Discussions on Financing Assurances in Fund-Supported Program" (February 9, 1988 - Buff 88/27).

become more difficult to predict the precise balance of payments implications of a financing package. Consequently, waiting for the critical mass has become a less effective way of encouraging early participation by the banks in a financing package. Only in the case of the largest debtors, has the prospect of prolonged deadlock created serious problems for the banks. In smaller debtor countries, banks sometimes fear that agreement on the terms proposed, however reasonable they may seem in the case in hand, may create undesirable precedents for other, larger debtors. This was one of the reasons why the Executive Board approved a stand-by arrangement with Costa Rica in 1987 and concluded two reviews of the arrangement in 1988 without insisting on the confirmation from banks that the required financing was forthcoming.

Furthermore, with the growing recognition that there are countries whose debt-servicing and balance of payments difficulties cannot be overcome without debt reduction, and with international agreement on a modified debt strategy, more emphasis has to be placed on the structure of financing packages, their composition, and their terms. One implication of longer and more complex menus is that the precise impact of their implementation on the balance of payments cannot be known with certainty. Recent experience has also underlined the fact that, with the continued erosion of bank cohesion, the expansion of the menu, and the need for agreement on debt-reducing items, considerably longer delays must be expected before agreement can be obtained for appropriate financing packages. Some spokesmen of the banking community have recently warned that packages involving debt and debt-service reduction for even the large debtors may now take 9-12 months to be completed. As a consequence, an approach which requires waiting for certainty that all parties will agree to the package, may result in the Fund and some other creditors being unable to commit their resources at the time when support is most essential. Such delays can undermine or thwart the adjustment effort, lead to a continuation of disorderly relations with creditors, and postpone progress toward medium-term external viability. To put it another way, an attempt to continue in present circumstances the policies that had been appropriate earlier would not be likely to ensure that the objectives of those policies would still be attainable.

III. The Objectives of the Financing Assurances Policy

In the circumstances described above, how can the objectives of the Fund's policy on financing assurances best be achieved? The specific objectives of the financing assurances policy must be assessed in the context of broader Fund objectives: to support members' economic adjustment programs; to catalyze resources from other creditors; and to give the Fund an assurance that it can be repaid. More specifically, the financing assurances policy should:

-- ensure that a program is fully financed, thus giving the member the support it needs to implement its economic adjustment program; and

-- ensure that the financing of the program is consistent with the member's return to viability.

In these ways, the Fund and other creditors receive the best available assurance that the country will be in a position to repay them. The Fund and multilateral development institutions are, of course, also protected by their preferred creditor status. In the context of the debt strategy, the policy on financing assurances has the further aims of ensuring that a cooperative solution to the member's problems is found, with the financing burden shared fairly among creditors; and of promoting the maintenance or reestablishment of orderly relations between the country and its creditors. The policy has sometimes been seen as putting pressure on either the country or its creditors to reach an agreement. While the incidence of any pressure may have varied from country to country and over time, the policy was designed to be impartial.

The achievement of the above objectives in current circumstances requires further consideration.

1. The support of strong adjustment efforts

The Fund's assistance to its members is intended to give them confidence to adopt the policies needed to restore their external payments position without having to sacrifice growth unduly. In addition to providing its own resources, the Fund seeks to catalyze the further exceptional balance of payments support the member needs. Other things being equal, the earlier this support can be provided or the more confident the member can be that the support will be there should it be needed, the more likely it is that the member will be able to launch a strong program of economic adjustment. Conversely, doubt about the extent of the commitment of the international financial community is likely to undermine the adjustment effort.

If the adjustment program is not supported with adequate cash flow, it will be undermined, as international reserves decline, imports are compressed, and capital outflows occur. In the past, bridge finance from official creditors or interim financing from commercial banks has sometimes been important for reducing the pressures on a country's cash flow at the start of a program and giving reassurance to market participants. However, both official and commercial creditors are becoming increasingly reluctant to provide such bridge finance, and the prospect of longer negotiations with creditors will lengthen the period during which any bridge would need to be in place.

There is the danger that, should there be long delays, disbursements of the Fund's resources would take place under circumstances markedly different from those originally envisaged. When this occurs, the quantitative base of the program has to be reworked and, if in the meantime the economic position of the member has deteriorated, further action may be required. Such developments would

not form the best starting point from which to launch new economic policies. Thus every effort needs to be made to ensure that the Fund, and official creditors who make their support dependent on the Fund's actions, can contribute in a timely fashion and thus strengthen the authorities' commitment to the adjustment effort and the chance of its success.

With the stronger position of the commercial banks and the need for some agreements with commercial banks to incorporate debt and debt-service reduction, delays will inevitably increase. Thus, debtor countries are likely to find themselves facing more severe cash flow problems. Prompt support by the Fund and the international community of a strong adjustment program will, on occasion, require either larger scale bridge financing or the Fund to disburse before such agreement is reached, despite the dangers of this approach. A main danger is that, if the country were making payments to creditors with which it was still negotiating the terms of an agreement, but from whom the program envisaged a financing contribution, disbursements from the Fund and official creditors would in effect be passed on to the former group of creditors, thus reducing their incentives to complete the negotiations rapidly. If the Fund and official creditors were to disburse under these circumstances, it would seem essential that the country not permit its reserves to fall below the level targeted in the adjustment program supported by the international community. This may mean that, unless resources are provided through official or commercial bank bridge finance, the country may not be able to service fully its payments to other creditors beyond the net amounts assumed in the program.

2. Viability and the closing of financing gaps over the medium term

In the application of policies on the use of Fund resources, the Fund has, also with the help of medium-term balance of payments scenarios, sought to assess whether a member would reach a viable position from which it can repay the Fund. The Fund's policy on financing assurances has focused in practice on closing financing gaps during the period of a stand-by arrangement, or during the first year of a multiyear arrangement. If gaps were not closed during this period, the path to balance of payments viability would be in doubt, and the Fund would be less sure that it would be repaid from a position of balance of payments strength. But satisfactory assurance of repayment depends also both on continued pursuit of adjustment policies and on the closing of subsequent payments gaps up to the time repurchases have been completed. It has not been feasible for the Fund to insist that creditors commit themselves to provide resources for several years ahead; indeed, the Fund itself is unwilling to do so for a period beyond the length of a multiyear arrangement; moreover, although the Fund's commitments are conditional, it can have no certainty that after the completion of the program, sound economic policies will continue to be implemented. The Fund has therefore generally relied on the projected financing gaps being of a size that can reasonably be expected to be covered and that converge on a viable balance of payments position.

It is now clear that, for certain members, the restoration of balance of payments viability will require some debt or debt-service reduction in the medium-term. In these cases, the provision of new money on commercial terms to the exclusion of debt reduction would not be consistent with a return to viability or the repayment of the Fund. Thus the form of the financing packages agreed with creditors becomes vitally important. The Fund therefore needs to be assured that the structure and the nature of the financing package is broadly appropriate and consistent with the support the Fund itself is providing. This assessment is made through the analysis of various medium-term scenarios for the member illustrating the circumstances under which the balance of payments could move toward viability.

For some members, future financing packages must be expected to contain a combination of new financing and instruments specifically providing for a reduction in contractual payments, such as below-market interest rates on old debt or new bonds, in addition to any provision of waivers to allow voluntary debt-reduction operations. Any temporary accumulation of arrears during the negotiation of the package would have to be regularized once agreement was reached. If some banks were to provide their contribution in the form of new claims, while the country required debt or debt-service reduction, the waivers should permit sufficient debt reduction for the package as a whole to be consistent with viability. In practice, the amount of resources immediately available to conduct debt-reduction operations may fall short of that required to achieve viability. The Fund would nevertheless be seeking to ensure that a start was made on the necessary process of debt or debt-service reduction.

It may also be that the banks will not agree to giving blanket assent to the desired debt-reduction operations, but may qualify their assent in various ways. Furthermore, the precise financing implications of debt-reduction may not be known at the outset. Thus, for example, the impact of a buy-back on the balance of payments over the medium term will depend on the price obtained, the phasing, and the cost of the funds being used to finance the operation. Judgment will therefore be required before deciding that adequate debt-reduction possibilities have been agreed. The Fund must maintain its insistence that there be adequate safeguards to secure repayment, and to do this it must continue to be able to show that a member's program and adjustment path are appropriately funded and consistent with balance of payments viability. It has therefore to be concerned about the impact of the financing package not only in the first year of a program, but also in subsequent years. The inclusion of appropriate debt-reduction operations in some financing packages can thus strengthen the Fund's assurance of being repaid.

3. Burden sharing

One reason for developing the financing assurances policy was to ensure that all groups of creditors which could expect to benefit from

the concerted effort to provide financing for a country's adjustment program would participate fairly in the provision of that support. While some smaller groups of creditors, for example bond-holders and unsecured suppliers, were generally exempted for practical reasons, others were expected to participate broadly in line with their relative exposure in providing the transitional financing needed to tide the country over to a point of balance of payments viability. This concept of burden sharing was apparent in the changes in the debt strategy that emerged from the September 1985 Annual Meetings.

In the event, the strategy and the financing assurances policy has been only partially successful in achieving this goal. While some commercial banks have taken losses on their exposure, not all have contributed commensurately with the debtor countries' needs, while the exposure of the bilateral and multilateral official sector has grown substantially in both absolute and relative terms. The policy on financing assurances needs to be modified so that those creditor groups, which are not willing to contribute, are not able to maintain and accumulate claims which would ultimately be paid out of the resources that other creditor groups are providing.

The temporary and exceptional nature of the problem of burden sharing has to be recognized. In normal circumstances, banks would bear the consequences of poor lending decisions, and the international community would have sufficiently well-funded instruments available to provide countries with such temporary balance of payment support as they need to finance adjustment programs that will allow them to restore their external payments position. Burden sharing became an issue during the debt crisis, because the abrupt termination of commercial bank financing created financing needs of such magnitude that the official community was neither prepared to meet them fully nor willing to be seen as bailing out the banks.

4. Orderly relations with creditors

One of the Fund's primary functions is to promote orderly relations between a country and its creditors. Arrears on debt service obligations are normally an indication of difficulties in such relations. The Fund has encouraged debtors to remain current, in particular with their interest payments, while temporary arrears on principal have often been less of a problem as eventual rescheduling was considered likely, and thus also accepted by creditors. In the past, bridge financing from different creditor groups helped to enable a country to remain current on its debt-service obligations. Fund-supported programs normally include a schedule for the elimination of any arrears.

The Fund's policy on financing assurances, combined with its policies on payments arrears, has been designed to promote orderly relations by encouraging where necessary the restructuring of creditors' claims on the country on terms compatible with balance of payments

viability. The policy on financing assurances has meant in effect that the Fund would only provide financial support once the member and its creditors had agreed on terms that were consistent with the program's balance of payments objectives. Meanwhile, the policies on payments arrears meant that creditors had strong assurances that the member would ultimately meet its obligations, although these might need to be renegotiated. However, the combination of the two policies now runs the risk of contributing to deadlock. On the one hand, certain creditors, having strengthened their balance sheets, have an interest in maintaining (or increasing) their claims on the debtor and are protected by the policies on payments arrears from the need to renegotiate and reduce those claims. On the other hand, the policy on financing assurances has begun to have the effect that, in the event of any delay in renegotiating claims on appropriate terms, support of the economic program had to be withheld.

The Fund's role must be seen as ensuring that the transition to normal relations with creditors is as orderly as possible. When the restoration of balance of payments viability requires the adoption of a financing package with a certain structure, possibly including debt-reduction elements, and this is prevented or delayed by the positions taken by certain creditors, there is the threat of a yet more disorderly situation, this time affecting both those prepared to cooperate and those unwilling to do so. In practice, if an economic program is not supported by all creditor groups in a timely way, the financing situation of a member vis-à-vis all its creditors, including the bilateral and multilateral, could be jeopardized at a time when a program is ready to be implemented and, as a result, arrears might develop to all creditor groups. All creditors should therefore benefit from the adoption of an appropriately structured financing package; in some circumstances, relations with creditors are likely to be more disorderly if there is an insistence that there be no arrears during the period when a financing package is negotiated. The Fund's policy should be aimed at creating a framework in which as orderly a resolution as possible of the member's financing difficulties can be arranged. This also means that creditors and debtors should start early with their negotiations on an appropriate financing package and, in particular, that financing needs in the later years of multiyear arrangements should be addressed well in advance.

Even if all creditors are urgently seeking to support good policies with adequate and appropriate financing, those whose negotiations are taking longest should not be in a position to benefit from the support being provided by others. The Fund's support of a strong adjustment program before agreement has been reached with all creditors could be undermined unless it were also decided to tolerate the temporary accumulation of arrears during the period of negotiation. In so doing, the Fund must also ensure, however, that the countries' adjustment effort is not weakened, and that Fund resources are not, in effect, diverted to the benefit of noncooperating creditors. This would also protect the interests of other creditors, for example the official

creditors organized in the Paris Club, who were contributing to the financing of the program.

There is inevitably a possibility that the arrangement might expire without the member and its commercial bank creditors having reached agreement. Even if the country has resources available to cover these arrears, there is no assurance, especially after the expiry of the program, that these resources will remain available to the banks. Although it would be deplorable, it cannot therefore be excluded that a program might end with an accumulation of arrears whose elimination will pose problems. Compared with the current situation, however, the country will have been given a strong incentive to adjust and considerable support to its adjustment effort during this period, and should therefore be in a stronger position and closer to viability than would otherwise have been the case.

During the period in which it is negotiating with its creditors, the country may not be in a position to make full payments, according to the contractual terms, nor, if it did so, might this be consistent with a return to balance of payments viability. In certain circumstances, it would be appropriate to exclude from the coverage of any performance criterion on arrears the temporary accumulation of arrears on the service of debt owed to creditors with whom negotiations are continuing. The Fund's policy on the approval of exchange restrictions giving rise to arrears raises different issues from the treatment of arrears in programs. In the past, the Fund has only approved such restrictions during what was envisaged to be a well-specified period required for the member to eliminate them, either through restructuring or by cash payment.

IV. The Process of Negotiations with Commercial Banks

How is it envisaged that negotiations of a member with its commercial bank creditors will be conducted in the future, and what will be the reaction of the commercial banks to this evolution in the policy on financing assurances? Once the member has drawn up its adjustment program and financing plan and is assured of broad official international support for this strategy, it will approach its commercial bank creditors, although preliminary contacts may well have taken place while the program was being negotiated. The country will request a financing package that would both fill financing gaps and be consistent with reaching viability in the medium term, and, if debt or debt-service reduction would contribute to such viability, the waiver of certain clauses in its loan agreements. It would probably propose to the banks that there be a standstill on principal (unless a MYRA is in place which already provides for this) and, where it faces cash flow constraints which cannot be removed by timely and adequate interim financing, possibly seek a deferral of some interest payments pending the outcome of the negotiations. In addition to the required waivers, the country would seek agreement with the banks on a broad menu of financing options, probably including new money to refinance interest payments, and possibly interest capitalization and reduced interest rates.

This request would not necessarily require an individual bank to forego its claims on the country, or the interest payable on the claims, although there might be an indeterminate delay in the settlement of such claims if it was unwilling to recontract on the terms agreed to by others. Once the necessary waivers have been given, banks would be free to sell their claims on the country, to exchange them at a discount, or to retain them. Provided the waivers were of sufficient breadth, the country could begin to make use of amounts drawn from the Fund and other creditors which had been set-aside for support of debt-reduction operations. The Fund would be looking both at the extent of the waivers and the composition of the financing package to ensure their compatibility with the program's assumptions. The Fund would not be involved in depriving any bank of a claim on the member.

During the negotiations on the package, the country might, in some cases, accumulate interest arrears to the commercial banks. It is possible that the banks might react to this approach by cutting trade lines or interbank exposure. Such a tactic could put considerable pressure on the country. To counter this, the country might have to be ready, with the support of the international community, to seek to freeze and consolidate existing exposure under such arrangements to reduce the extent of balance of payments pressures emerging from this source, although experience shows that such pressures would not be completely neutralized. It is unlikely that either party would benefit from such an escalation of pressures. If the country is negotiating in good faith on a package that will enhance its balance of payments viability, it will not be in the interest of the banks to engage in such punitive measures and to jeopardize continuing business interests.

Continuation of the cooperative approach would also be encouraged by a provision that arrears would only be tolerated under a program while the country was implementing a strong adjustment program and participating cooperatively in negotiations. The Fund staff would continue to make their views known to the member and the steering committee as to the member's needs for rescheduling and financing, including debt or debt-service reduction, if any. The member would thus need to maintain a negotiating position toward its commercial bank creditors that was broadly consistent with the assumptions of the adjustment and financing program being supported by the international community.

Another danger is that the accumulation of arrears could be interpreted by some as a breakdown in the cooperative approach, and there could even be a tendency for capital flight to increase. To avoid this, and to give the banks an incentive to keep their trade and interbank lines open, particular and early attention needs to be paid to an appropriate exchange and interest rate policy. It should also be noted that, by preventing lengthy uncertainty about the international community's support of the country's adjustment effort, an incentive for capital flight will be reduced. To inform banks fully about the program assumptions, to encourage banks' participation in such an approach, to

understand the banks' case better, and to monitor and keep the process orderly in general, Fund staff would have to ensure that contacts with advisory committees are adequate to allow the staff to provide the necessary flow of information to the Board. The staff's involvement in discussions between banks and a member country would remain purely technical.

V. The Required Adaptation of the Approach to Financing Assurances

The policy on financing assurances should promote the provision of financing and restructuring that is consistent with the achievement of external viability by the member in the medium term. In so doing, it should seek to ensure that programs are adequately financed, that Fund support catalyzes support from others, and that the Fund's resources are provided in circumstances that give the Fund an assurance of being repaid. In cases where concerted new money remains the appropriate and major form of commercial banks' contribution to closing a financing gap, present practices, including seeking a critical mass before a program becomes effective, will be continued. Such cases, however, may become less frequent in the immediate future. But any modification of past practices on financing assurances needs to be based on prudent flexibility applied on a case-by-case basis; should build on the present policy; and must foster the achievement of the objectives discussed above.

Building on the flexibility provided during the 1988 review, certain modifications would be called for in cases where commercial bank creditors were likely to need time to agree to their share in an internationally endorsed financing package designed to achieve balance of payments viability. In modifying the policy on financing assurances, it would be essential to review the effectiveness of the changes in emphasis adopted after applying them for a period of, say, one year.

While the objectives of the policy remain unchanged, its adaptation would be specifically designed:

-- to ensure that the necessary financing was available to the country to support the first year of the adjustment program and if possible beyond this period;

-- to ensure that any extra resources temporarily available to the country were used in ways that would contribute to a more rapid return to a sustainable balance of payments position; and

-- to give the banks an incentive to reach agreement with the member on a restructuring and reduction of their claims that was compatible with balance of payments viability and with the banks' bearing their share in the financing burden;

-- to limit any temporary arrears accumulation to the minimum that might be unavoidable during negotiations, and to confine such arrears to those on the service of claims under renegotiation.

Management would continue to consult informally with the Executive Directors in cases where the application of the modified policy was envisaged.

The Fund should be prepared to approve outright an arrangement with a member before agreement on a suitable financing package has been agreed with creditors in cases where negotiations with creditors proved to be prolonged, and where it was judged that such prompt Fund support was essential to the economic program, subject to the existence of adequate safeguards for the Fund and other creditors that the resources they are providing in support of the adjustment program are being used appropriately. The program would nevertheless be based on the assumption that a financing package could be reached with the creditors that would permit the restoration of balance of payments viability within the necessary time frame. The program and financing package would be based on the judgment that the member was doing all that could reasonably be expected of it to meet its contractual obligations to its creditors. In these cases, the Fund would be prepared to make disbursements under the arrangement for the first six months of the arrangement, during which time the country would commit itself to pursue negotiations with its commercial bank creditors on a financing package. Performance criteria under stand-by or extended arrangements would be quarterly while agreement was not reached with creditors. There would be no intention of modifying the policy of financing assurances as far as official creditors were concerned.

If there were still no agreement with creditors after, perhaps, six months, progress under the arrangement and in the negotiations would be reviewed. There would be a presumption that, if the country was implementing the adjustment program and was negotiating on the basis of a position no less favorable to the creditors than the assumptions underlying the program, purchases under the arrangement would then be permitted until the time of a further review. There would also be a review once agreement had been reached with creditors to ensure that its terms were consistent with the financing requirements of the program.

To provide the safeguards to the Fund and other creditors mentioned above, the Fund would need to ensure that, during the negotiations, the country was not jeopardizing its reserve targets and in effect using the resources to service other, noncooperating creditors. To the extent that the country's cash flow did not permit the full servicing of banks' claims, arrears on interest payments due to banks would be tolerated in the economic program up to the amount that banks are expected to provide as their share of filling the projected financing gap. Arrears on amortization payments would also continue to be allowed in cases where rescheduling of principal was under negotiation. Consequently, the performance criterion on arrears would exclude such arrears. As clear a

distinction as possible would be made between payments on debt subject to negotiation, on which certain arrears would be tolerated, and payments on other bank debt, such as trade finance or interbank lines, whose restructuring was not envisaged and which would continue to be serviced normally. The basic assumption would be that the financing package--whatever its composition--would eventually regularize the accumulated arrears. The objective would be to ensure that resources of the Fund, or of other creditors provided in support of the adjustment program, not be used to pay off creditors who are not contributing to a cooperative solution of the problem.

Nevertheless, it may not be advisable to limit formally the incurrence of arrears only to those that are expected ultimately to be refinanced by banks. Depending on the course of the negotiations between the member and the commercial banks, some part of the interest due that was assumed not to be refinanced in the financing package, might also fall into arrears. This approach would appear necessary so as not to involve the Fund in detailed negotiations between the member and its bank creditors. However, the program would require the country to retain resources equivalent to those debt-service obligations that will not be refinanced but are not being paid immediately, so that such resources can be made available to the creditors once agreement is reached. Either the net international reserves target of the program could be adjusted to ensure that gross reserves are accumulated; or a commitment could be sought from the country to put these amounts into special accounts, to be released only after agreement has been reached with banks.

The Fund's current policy on payments arrears requires a schedule for the elimination of arrears from the outset of a Fund-supported program. Under a modified policy on financing assurances, there is a risk that arrears may accumulate during a longer period of time than previously. The question of approval or nonapproval of exchange restrictions giving rise to arrears was raised in the recent cases of Argentina, Bolivia, Costa Rica, and Venezuela. In view of the diverse experience in these cases and the expectation that this question will need to be addressed more frequently in the future, the staff is preparing a review of these issues.

The proposed modification of the Fund's approach to financing assurances entails risks. The proposal presented above is designed to minimize those risks and to keep the transition to debt or debt-service reduction for certain debtor countries as orderly as possible so that the Fund can continue to play its central role of assisting member countries in implementing appropriate adjustment programs. Above all it is intended to avoid the more significant risks which would be inherent in any attempt to maintain the existing policies in circumstances in which they cannot achieve their objectives.